RADWARE LTD
Form 20-F
June 05, 2007

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 20-F

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

OR

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

For the fiscal year ended December 31, 2006

OR

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

For the transition period from __________ to __________.

OR

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

Date of event requiring this shell company report _________

Commission file number 0-30324

RADWARE LTD.
(Exact name of Registrant as specified in its charter)

Israel
(Jurisdiction of incorporation or organization)

22 Raoul Wallenberg Street, Tel Aviv 69710, Israel
(Address of principal executive offices)

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

Title of each class	Name of each exchange on which registered
Ordinary Shares, NIS 0.1 par value per share	**NASDAQ Global Market**

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

(Title of Class)

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

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

19,411,903 Ordinary Shares, NIS 0.1 par value per share

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

o Yes x No

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

o Yes x 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.

x Yes o No

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

Large Accelerated Filer o Accelerated Filer x Non-Accelerated Filer o

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

o Item 17 x Item 18

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

o Yes x No

INTRODUCTION

As used in this annual report, the terms “we,” “us,” “our,” the “Company,” and “Radware” mean Radware Ltd. and its subsidiaries, unless otherwise indicated. The references to "Companies Law" or the “Israeli Companies Law” are to the Israeli Companies Law, 5759-1999 (as amended).

CAUTIONARY STATEMENT REGARDING FORWARD-LOOKING STATEMENTS

Except for the historical information contained herein, the statements contained in this annual report are forward-looking statements, within the meaning of the Private Securities Litigation Reform Act of 1995 with respect to our business, financial condition and results of operations. Actual results could differ materially from those anticipated in these forward-looking statements as a result of various factors, including all the risks discussed in “Risk Factors” and elsewhere in this annual report.

We urge you to consider that statements which use the terms “believe,” “do not believe,” “expect,” “plan,” “intend,” “estimate, “anticipate,” and similar expressions are intended to identify forward-looking statements. These statements reflect our current views with respect to future events and are based on assumptions and are subject to risks and uncertainties. Except as required by applicable law, including the securities laws of the United States, we do not intend to update or revise any forward-looking statements, whether as a result of new information, future events or otherwise.

We have registered trademarks for “Web Server Director®,” “Cache Server Director®”, “FireProof®”, “LinkProof®”, “Triangulation®”, “Smart Nat®”, “Get Certain®”, “CertainT®”, “Peer Director®”,, “Synapps Architecture®”, “DefensePro® “StringMatch Engine®” and “CID - Content Inspection Director®” and we have trademark applications pending for “UpLink™”, “Radware™”, “APSolute™”, “AppDirector”™, “AppXCel”™, “SecureFlow”™, “SOADirector”™, “SOASwitch”™, “SIP “DFI- Deep Flow Inspection”™. All other trademarks and tradenames appearing in this annual report are owned by their respective holders.

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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

Selected Financial Data

The following tables present our consolidated statement of operations and balance sheet data for the periods and as of the dates indicated. We derived the statement of operations for the years ended December 31, 2004, 2005 and 2006 and the balance sheet data as at December 31, 2005 and 2006 from our audited consolidated financial statements included elsewhere in this annual report, which have been prepared in accordance with generally accepted accounting principles in the United States ("U.S. GAAP"). The selected consolidated statement of operations financial data for the years ended December 31, 2002 and 2003 and the balance sheet data for the years ended December 31, 2002, 2003 and 2004 are derived from our audited consolidated financial statements not included in this annual report, which have been prepared in accordance with U.S. GAAP. *You should read the following selected financial data together with the section of this annual report entitled "Operating and Financial Review and Prospects" and our consolidated financial statements together with the notes thereto included elsewhere in this annual report.* Please see notes 2Q and 12B of the notes to our consolidated financial statements for an explanation regarding the computation of basic and diluted net earnings (loss) per ordinary share.

	Year ended December 31, 2002	Year ended December 31, 2003	Year ended December 31, 2004	Year ended December 31, 2005	Year ended December 31, 2006
			(US $ in thousands, except per share data)		
Statement of Operations Data:					
Revenues	$ 43,663	$ 54,780	$ 68,439	$ 77,584	$ 81,410
Cost of revenues	7,946	9,854	12,184	14,896	15,791
Gross profit	35,717	44,926	56,255	62,688	65,619
Operating expenses:					
Research and development, net	7,809	8,398	10,342	13,017	17,659
Sales and Marketing	30,019	29,753	31,898	40,002	50,128
General and administrative	4,219	4,120	4,493	5,244	6,178
Total operating expenses	42,047	42,271	46,733	58,263	73,965
Operating profit (loss)	(6,330)	2,655	9,522	4,425	(8,346)
Financial income, net	4,240	3,740	4,565	5,159	7,422
Income (loss) before income taxes	(2,090)	6,395	14,087	9,584	(924)
Income taxes	-	-	(341)	(240)	(356)
Minority interest in losses (earnings) of a subsidiary	(23)	(40)	34	-	-
Net income (loss)	$ (2,113)	$ 6,355	$ 13,780	$ 9,344	$ (1,280)
Basic net earnings (loss) per share	$ (0.13)	$ 0.37	$ 0.77	$ 0.50	$ (0.07)
Diluted net earnings (loss) per share	$ (0.13)	$ 0.34	$ 0.70	$ 0.47	$ (0.07)

	Year ended December 31, 2002	Year ended December 31, 2003	Year ended December 31, 2004 (in thousands)	Year ended December 31, 2005	Year ended December 31, 2006
Weighted average number of ordinary shares used in computing basic net earnings (loss) per share	16,655	17,184	17,995	18,800	19,325
Weighted average number of ordinary shares used in computing diluted net earnings (loss) per share	16,655	18,666	19,805	20,072	19,325

			December 31,		
	2002	2003	2004 (US $ in thousands)	2005	2006
Balance Sheet Data:					
Cash and cash equivalents, short-term bank deposits and marketable securities and current maturities of long-term bank deposits	$ 52,274	$ 62,882	$ 109,020	$ 126,901	$ 140,375
Long-term bank deposits, structured note and marketable securities	73,027	76,139	48,021	37,592	23,756
Working capital	50,690	60,477	107,687	124,005	137,406
Total assets	142,998	158,114	183,241	204,347	215,668
Shareholders' equity	127,357	140,246	160,917	177,426	182,414

Risk Factors

Our business, operating results and financial condition could be seriously harmed due to any of the following risks. The following risks are not the only risk factors facing our Company. Additional risks and uncertainties not presently known to us or that we currently deem immaterial may also affect our business. The trading price of our ordinary shares could decline due to any of these risks.

Risks Related to Our Business and Our Industry

We have incurred losses in the past, and may incur losses in the future

While we were profitable in each of the years 2003-2005, we incurred losses in 2002 and 2006. We had net loss of approximately $1.3 million in 2006, and net income of $9.3 million in 2005, $13.8 million in 2004 and $6.4 million in 2003. We incurred net losses of approximately $2.1 million in 2002. We will need to generate increased revenues as well as manage our costs to return to and maintain profitability. In 2006 we incurred losses as a result of increased expenses incurred in our efforts to significantly increase our revenues, coupled with only moderate revenue growth for the year, mainly due to the inability of our US sales force to ramp up sales in the Americas. We cannot assure you that we will be able to return to or maintain profitability. Our gross margin is currently approximately 81%. As a result, any decrease in sales may have a significant effect on our profitability.

Our revenues may not grow or continue at their current level. For example, the growth rate in 2004 compared to 2003 was approximately 25%, whereas the growth rate in 2005 compared to 2004 was approximately 13% and the growth rate in 2006 compared to 2005 was approximately 5%. In addition, our operating expenses may continue to increase. Our decision to increase operating expenses and the scope of such increase will depend upon several factors, including the market situation and the results that our past expenditures produce. We may continue to make additional expenditures in anticipation of generating higher revenues, which we may not realize, if at all, until some time in the future. For example, during 2006 we restructured our sales force in the United States in an effort to increase the effectiveness of our sales efforts in this market. Our efforts as well as our expenditures in this restructuring may not result in increased revenues. If our revenues continue not to increase as anticipated, or if our expenses increase at a more rapid pace than revenues, we may continue to incur losses.

Our results for 2006 were benefited by financial income in an amount of approximately $7.4 million. We cannot assure you that we will be able to generate financial income in the future or that such financial income will remain at the same level.

Volatility of the market for our products, including slow-down in expenditures by service providers, e-commerce businesses and other trends in our industry could have a material adverse effect on our results of operations.

Our business is dependent on current and anticipated market demand for our products. Beginning in late 2000, market demand was negatively impacted by the general deterioration of the global economy and the economic uncertainties in the telecommunications market. These conditions, and the uncertainties surrounding the growth rates of economies worldwide, resulted in a curtailment of capital investment by companies in our target markets and caused our revenue growth to increase at a significantly slower pace during 2001 and 2002 relative to prior years. According to our estimates, in 2003, the market remained substantially flat and in 2004 through 2006 there was an improvement in the market. Due to the past volatility of the market it is difficult to predict the conditions of our market going forward. In addition, we believe that market conditions could cause our customers and potential customers to be more conservative in planning their spending. If the global conditions deteriorate, and companies in our target markets reduce capital expenditures, we may experience a reduction in sales, as well as downward pressure on the price of our products. In addition, if the market is flat and customers experience low visibility we may not be able to increase our sales. Each of the above scenarios would have a material adverse effect on our business, operating results and financial condition.

We may experience significant fluctuations in our quarterly financial performance because of the factors discussed below and seasonal fluctuations in our sales.

Our quarterly operating results have varied significantly in the past and may vary significantly in the future as a result of various factors, many of which are outside of our control. These factors include:

- Our limited order backlog;
- Our need to develop and introduce new and enhanced products; and
- The long sales cycles of our products.

As a result of the foregoing our results in any quarter may also fall below projected results. For example, in the first quarter of 2007 our revenues were approximately $1.5 million less than projected at the beginning of the quarter.

In addition, our quarterly operating results have been, and are likely to continue to be, influenced by seasonal fluctuations in our sales. Because our sales have grown significantly since inception, these fluctuations may not be

apparent from our historical financial statements. However, we believe that our sales and sales growth have been, and will continue to be, affected by the seasonal purchasing patterns of some of our customers. For example, we believe that our sales may be reduced from the levels which we might otherwise have been able to attain during the third quarter of 2007 because of the slowdown in business activities during the summer months in Europe, and that our sales during the fourth quarter of 2007 may be increased because some of our customers tend to make greater capital expenditures towards the end of their own fiscal years. Because of these anticipated fluctuations, our sales and operating results in any quarter may not be indicative of future performance and it may be difficult for investors to properly evaluate our prospects.

If the market for Application Delivery and Network Security solutions does not continue to develop, we will not be able to sell enough of our products to achieve and maintain profitability.

The Application Delivery and Network Security markets in which we operate are rapidly evolving and we cannot assure you that they will continue to develop and grow or that our products and technology will keep pace with these changes. Market acceptance of Application Delivery and Network Security solutions may be inhibited by, among other factors, a lack of anticipated congestion and strain on existing network infrastructures and the availability of alternative solutions. If demand for Application Delivery and Network Security solutions does not continue to grow, we may not be able to sell enough of our products to achieve, maintain and increase profitability.

Competition in the market for Application Delivery and Network Security solutions is intense. As a result, we may lose market share and we may be unable to achieve and maintain profitability.

The Application Delivery and Network Security markets are highly competitive and we expect competition to intensify in the future. We may lose market share if we are unable to compete effectively with our competitors. Our principal competitors in the Application Delivery solutions market include: F5 Networks, Inc., Cisco Systems, Inc., Citrix Systems, Inc. Foundry Networks, Inc., and Juniper Networks, Inc. In addition, we face competitors in the Network Security space, with respect to our Intrusion Prevention Systems (IPS). Such principal competitors include Juniper Networks, Inc., 3Com Systems, Inc. (TippingPoint), McAfee, Inc., Sourcefire, Inc., and IBM Corporation (Internet Security Systems). We expect to continue to face additional competition as new participants enter the market. Larger companies with substantial resources, brand recognition and sales channels may form alliances with or acquire competing Application Delivery or Network Security solutions and emerge as significant competitors. For example, IBM Corporation became a competitor in the Network Security market by acquiring Internet Security Systems (ISS). Competition may result in lower prices or reduced demand for our products and a corresponding reduction in our ability to recover our costs, which may impair our ability to achieve, maintain and increase profitability. Furthermore, the dynamic market environment, which is demonstrated by the above acquisitions, poses a challenge in predicting market trends and expected growth.

Most of our competitors have greater resources than us, which may limit our ability to effectively compete with them.

Most of our competitors have greater financial, personnel and other resources than us, which may limit our ability to effectively compete with them. These competitors may be able to:

- respond more quickly to new or emerging technologies or changes in customer requirements;
- benefit from greater economies of scale;
- offer more aggressive pricing;
- devote greater resources to the promotion of their products; and/or
- bundle their products or incorporate an Application Delivery or Intrusion Prevention component into existing products in a manner that renders our products partially or fully obsolete.

We must develop new products and enhancements to existing products to remain competitive. If we fail to develop new products and product enhancements on a timely basis, we may lose market share.

The markets for Application Delivery and Network Security solutions are characterized by rapid technological change, frequent new product introductions, changes in customer requirements and evolving industry standards.

Accordingly, our future success will depend to a substantial extent on our ability to:

- invest significantly in research and development;
- develop, introduce and support new products and enhancements on a timely basis; and
- gain and consecutively increase market acceptance of our products.

We are currently developing new products and enhancements to our existing products. We may not be able to successfully complete the development and market introduction of new products or product enhancements. If we fail to develop and deploy new products and product enhancements on a timely basis, or if we fail to gain market acceptance of our new products, our revenues will decline and we may lose market share to our competitors. For example, during 2006, we introduced additions to our next generation APSolute application delivery product family. During 2006, we also invested, and plan to continue to invest in 2007, in developing or when appropriate, acquiring, capabilities to advance our APSolute product family and market vision for application-smart networking. As evidence of 2007 investments, we acquired Covelight Systems, Inc. ("Covelight") in April for their web channel intelligence technology that allows business events to be captured in real-time on the network. This strategic move is intended to increase the market relevance of our APSolute product portfolio. We also released v3.10 of our DefensePro software with support for IPv6 and worm propagation prevention and added web application firewall (WAF) services to our AppXcel service platform through an OEM partnership with Imperva. These investments are part of our new positioning initiative branded as "business-smart networking". There is no assurance that we will be successful in marketing and selling our next generation Application Delivery and Network Security solutions or the Covelight solutions, or that we will be able to grow revenues to justify our investments.

We may make acquisitions or pursue mergers that could disrupt our business and harm our financial condition.

As part of our business strategy, we may invest in or acquire other businesses, technologies or assets, or we may enter into joint ventures or other strategic relationships with third parties. For example, in the last two years we acquired the businesses of V-Secure and Covelight. We may assume liabilities or write-offs, incur amortization expenses related to intangible assets or realize large and immediate write-offs in connection with future acquisitions. In addition, the future valuation of these acquisitions may decrease from the market price paid by us, which may result in the writing-off, or impairment, of the relevant assets. In addition, our operation of any acquired or merged businesses, technologies or assets could involve numerous risks, including:

- Post-merger integration problems resulting from the combination of any acquired operations with out own operations or from the combination of two or more operations into a new merged entity;
- Diversion of management's attention from our core business;
- Substantial expenditures, which could divert funds from other corporate uses;
- Entering markets in which we have little or no experience; and
- Loss of key employees of the acquired operations.

We cannot be certain that our recent acquisitions or any future acquisition or merger will be successful. If the operation of the business of any recent or future acquisitions or mergers disrupts our operations, our business may suffer. In addition, even if we successfully integrate the acquired business with our own, we may not receive the intended benefits of the acquisition.

We have a very limited order backlog. If revenue levels for any quarter fall below our expectations, our earnings will decrease.

We have a very limited order backlog, which makes revenues in any quarter dependent on orders received and delivered in that quarter. A delay in the recognition of revenue may have a significant negative impact on our results of operations for a given period. We base our decisions regarding our operating expenses on anticipated revenue trends, and our expense levels are relatively fixed, or require some time for adjustment. Because only a small portion

of our expenses varies with our revenues, if revenue levels fall below our expectations, our earnings will decrease.

We depend upon independent distributors to sell our products to customers. If our distributors do not succeed in selling our products, our revenues will suffer.

We sell our products primarily to independent distributors, including value added resellers, original equipment manufacturers and systems integrators. These distributors resell our products to the ultimate customers. We currently have over 200 active independent distributors and resellers that sell our products. We are highly dependent upon our distributors' active marketing and sales efforts. Our distribution agreements generally are non-exclusive, one-year agreements with no obligation on the part of our distributors to renew the agreements. Typically, our distribution agreements do not prevent our distributors from selling products of other companies, including products that may compete with our products, and do not contain minimum sales or marketing performance requirements. As a result, our distributors may give higher priority to products of other companies or to their own products, thus reducing or discontinuing their efforts to sell our products. We may not be able to maintain our existing distribution relationships. If our distributors terminate their relationships with us, we may not be successful in replacing them. In addition, we may need to develop new distribution channels for new products and we may not succeed in doing so. Any changes in our distribution channels, or our inability to establish distribution channels for new products, will impair our ability to sell our products and result in the loss of revenues.

Our products generally have long sales cycles, which increase our costs in obtaining orders and reduces the predictability of our earnings.

Our products are technologically complex and are typically intended for use in applications that may be critical to the business of our customers. As a result, our sales process is often subject to delays associated with lengthy approval processes that typically accompany the design and testing of new equipment. The sales cycles of our products to new customers can last as long as twelve months from initial presentation to sale. This delays the time in which we recognize revenue, and results in our having to invest significant resources in marketing and sales.

Long sales cycles also subject us to risks not usually encountered in a short sales cycle, including our customers' budgetary constraints and internal acceptance reviews and processes prior to purchase. In addition, orders expected in one quarter could shift to another because of the timing of our customers' procurement decisions. Furthermore, customers may defer orders in anticipation of new products or product enhancements introduced by us or by our competitors. These factors complicate our planning processes and reduce the predictability of our earnings.

We must manage our anticipated growth effectively in order to achieve profitability.

We have actively expanded our operations in the past and may continue to expand them in the future in order to gain market share in the evolving market for Application Delivery and Network Security solutions. This expansion has required, and may continue to require, managerial, operational and financial resources.

We cannot assure you that we will continue to expand, or that we will be able to offer and expand our operations successfully. If we are unable to manage our expanding operations effectively, our revenues may not increase, our cost of operations may rise and we may not be profitable.

As we grow we may need new or enhanced systems, procedures or controls. For example, at the beginning of 2007, we implemented a company-wide Oracle ERP system, with a substantial investment of resources, in order to increase our efficiencies of our operations in the fields of finance, operations, customer support and order management. The transition to new systems, procedures or controls, as well as any delay in transitioning to new or enhanced systems, procedures or controls, may seriously harm our ability to accurately forecast sales demand, manage our product inventory and record and report financial and management information on a timely and accurate basis.

Our international sales may expose us to additional risks

We currently offer our products in over 40 countries in addition to the United States. In fiscal years 2005 and 2006 our sales outside the Americas represented approximately 59% and 66%, respectively, of our total sales. Our international business activity involves varying degrees of risk and uncertainty inherent in doing business in so many different jurisdictions. Such risks, among others, may include: the possibility of unfavorable circumstances arising from host country laws or regulations, including unexpected changes of interpretations thereof; partial or total expropriation; export duties and quotas; local tax exposure; insurrection or war; and differences in business practices. For example, we are required to comply with European Union Directives with respect to product quality assurance standards and environmental standards. In 2006, we were required to modify certain of our products in order to comply with Directive 2002/95/EC on Restriction of the Use of Certain Hazardous Substances in Electrical and Electronic Equipment (known as the "RoHs" Directive), which requires products sold in Europe to meet certain design specifications. We incurred costs and expenses and were required to spend management time and resources in the redesign of our products to meet the RoHs Directive.

Currency exchange rates and fluctuations of exchange rates could have a material adverse effect on our results of operations.

We are impacted by exchange rates and fluctuations thereof in a number of ways, including:

- A significant portion of our expenses, principally salaries and related personnel expenses, are paid in Israel shekels, whereas most of our revenues are generated in dollars and Euros. We have recently witnessed a significant strengthening of the shekel against the dollar, which has considerably increased the dollar value of our expenses in Israel. Should the shekel continue to maintain, or increase, its strength in comparison to the dollar, the dollar value of these expenses will continue to be high, and our results of operations will be adversely affected.

- A portion of our international sales are denominated in currencies other than dollars, such as the Euro, thereby exposing us to gains and losses on non-U.S. currency transactions.

- A substantial proportion of our international sales are denominated in dollars. Accordingly, devaluation in the local currencies of our customers relative to the dollar could cause customers to decrease orders or default on payment, which could harm our results of operations.

Our success depends on our ability to attract, train and retain highly qualified sales, technical and customer support personnel.

As we grow, we may need to increase our research and development, sales and marketing, and support staff. Our products require a sophisticated marketing and sales effort targeted at several levels within a prospective customer's organization. The integration of these solutions into existing networks and ongoing support can be complex. Accordingly, we need highly-trained sales, marketing and customer support personnel. Competition for qualified sales personnel, as well as technical and customer support personnel is intense, and we may not be able to hire sufficient personnel to support our research and development and sales and marketing efforts. Our success depends upon our ability to attract, train and retain highly qualified personnel.

We are dependent on Roy Zisapel, our President and Chief Executive Officer, the loss of whom would negatively affect our business.

Our future success depends in large part on the continued services of our senior management and key personnel. In particular, we are highly dependent on the services of Roy Zisapel, our President and Chief Executive Officer. Although we have employment contracts with our senior management and key personnel, we do not carry life insurance on our senior management or key personnel. Any loss of the services of Roy Zisapel, other members of senior management or other key personnel could negatively affect our business.

Undetected hardware defects and software errors may increase our costs and impair the market acceptance of our products.

Our products have occasionally contained, and may in the future contain, undetected defects or errors, especially when first introduced or when new versions are released, due to defects or errors we fail to detect, including in components supplied by third parties. These defects or errors may be found after the commencement of commercial shipments. In addition, our customers integrate our products into their networks with products from other vendors. As a result, when problems occur in a network, it may be difficult to identify the product that has caused the problem. Regardless of the source of these defects or errors, we will then need to divert the attention of our engineering personnel from our product development efforts to address the detection and correction of these errors and defects. In the past, we have not incurred significant warranty or repair costs, nor have we been subject to liability claims for damages related to product errors or defects nor experienced any material lags or delays as a result thereof. However, we cannot assure

you that we will not incur these costs or liabilities or experience these lags or delays in the future. Any insurance policies that we may have may not provide sufficient protection should a claim be asserted. Moreover, the occurrence of errors and defects, whether caused by our products or the components supplied by another vendor, may result in significant customer relations problems and injure our reputation, thus impairing the market acceptance of our products.

We rely on third-party manufacturing vendors to provide key components of our products. If USR Technologies and Electronics (2003) Ltd., or USR, is not able to provide us with adequate supplies of the principal component used in our products, we may not be able to deliver sufficient quantities of our products to satisfy demand, or may have a delay in fulfilling orders.

We rely on USR to supply us with circuit boards. These circuit boards are a principal component, which we use in the manufacture of our products. If we are unable to acquire circuit boards from USR on acceptable terms, or should USR cease to supply us with circuit boards for any reason, we may not be able to identify and integrate an alternative source of supply in a timely fashion or at the same costs. Any transition to one or more alternate suppliers would likely result in delays, operational problems and increased costs, and may limit our ability to deliver our products to our customers on time for such transition period. We entered into agreements with two additional suppliers, but to date have only purchased relatively small quantities from those suppliers. If we would need to rely on the alternate suppliers, there is no assurance that we will be able to obtain the quantities we require at lead times and pricing competitive to USR.

A shortage of components or manufacturing capacity could cause a delay in our ability to fulfill orders or increase our manufacturing costs

Our growth and ability to meet customer demands depend in part on our ability to obtain timely deliveries of parts from our suppliers and contract manufacturers. We may experience a shortage of certain component parts as a result of our own manufacturing issues, manufacturing issues at our suppliers or contract manufacturers, capacity problems experienced by our suppliers or contract manufacturers, or strong demand in the industry for those parts, especially if the economy grows. Growth in the economy is likely to create greater pressures on us and our suppliers to accurately project overall component demand and component demands within specific product categories and to establish optimal component levels. If shortages or delays persist, the price of these components may increase, or the components may not be available at all, and we may also encounter shortages if we do not accurately anticipate our needs. We may not be able to secure enough components at reasonable prices or of acceptable quality to build new products in a timely manner in the quantities or configurations needed. Accordingly, our revenues and gross margins could suffer until other sources can be developed. Our operating results would also be adversely affected if, anticipating greater demand than actually develops, we commit to the purchase of more components than we need. There can be no assurance that we will not encounter these problems in the future. Although in many cases we use standard parts and components for our products, certain components are presently available only from a single source or limited sources. We may not be able to diversify sources in a timely manner, which could harm our ability to deliver products to customers and seriously impact present and future sales.

Our profitability could suffer if third parties infringe upon our proprietary technology.

Our profitability could suffer if third parties infringe upon our intellectual property rights or misappropriate our technologies and trademarks for their own businesses. Our success depends upon the protection of our proprietary software installed in our products, our trade secrets and our trademarks. To protect our rights to our intellectual property, we rely on a combination of trademark and patent law, trade secret protection, confidentiality agreements and other contractual arrangements with our employees, affiliates, distributors and others. In the United States, we have registered trademarks for “Web Server Director®,” “Cache Server Director®”, “FireProof®”, “LinkProof®”, “Triangulation®”, “Smart Nat®”, “Get Certain®”, “CertainT®”, “Peer Director®”, “Synapps Architecture®”, “DefencePro®
StringMatch Engine®” and “CID - Content Inspection Director®”. We also have trademark applications pending for “UpLink™”, “Radware™”, “APSolute™”, “AppDirector”™, “AppXCell”™, “SecureFlow”™, “SOADirector”™, “SOASwitch”™, “SI
“DFI- Deep Flow Inspection”™. In addition, we have registered patents in the United States for our triangle redirection method used for the global load balancing, for our mechanism for efficient management and optimization of multiple links used in our LinkProof product, for our method for load balancing by global proximity used in our WSD product and for our method for controlling traffic on links between autonomous BGP systems. We also have pending patent

applications and provisional patents in connection with several features used in our products. The protective steps we have taken may be inadequate to deter misappropriation of our proprietary information. We may be unable to detect the unauthorized use of our proprietary technology or take appropriate steps to enforce our intellectual property rights. Effective trademark, patent and trade secret protection may not be available in every country in which we offer, or intend to offer, our products. Failure to adequately protect our intellectual property could devalue our proprietary content and impair our ability to compete effectively. Furthermore, defending our intellectual property rights could result in the expenditure of significant financial and managerial resources. For example, in 2004 we sued F5 networks Inc. for patent infringement and we settled in 2005. Although the lawsuit did not result in a significant expenditure we spent time and resources litigating and settling the claim.

Our products may infringe on the intellectual property rights of others.

Third parties may assert against us infringement claims or claims that we have violated a patent or infringed a copyright, trademark or other proprietary right belonging to them. As a result we may incur costs defending ourselves or settling lawsuits even if we believe we do not infringe third parties rights. For example, in 2003, F5 Networks, Inc. filed a lawsuit against us for patent infringement which was settled in 2004. The settlement included a license of the F5 patent.

Our non-competition agreements with our employees may not be enforceable in certain jurisdictions. If any of these employees leaves our Company and joins a competitor, our competitor could benefit from the expertise our former employee gained while working for us.

We currently have non-competition agreements with all of our employees. These agreements prohibit our employees, in the event they cease to work for us, from directly competing with us or working for our competitors for a limited period after termination of employment. The laws of the U.S., Israel and other countries in which we have employees, may limit or prohibit our ability to enforce these non-competition agreements, or may allow us to enforce them only to a limited extent. In the event that we are unable to enforce any of these agreements, competitors that employ our former employees could benefit from the expertise our former employees gained while working for us.

Some of our deposits and other investments may be in excess of insured limits and are not insured in other jurisdictions.

The majority of our cash and cash equivalents, and short-term and long-term bank deposits are invested in banks in the United States and the U.K.. Some of these deposits may be in excess of insured limits and are not otherwise insured. If one or more of these financial institutions were to become insolvent, the loss of these investments would have a material adverse effect on our financial condition.

Risks Related to the Market for Our Ordinary Shares

Two shareholders may exert significant influence in the election of our directors and over the outcome of matters requiring shareholder approval.

As of June 3, 2007, Mr. Yehuda Zisapel, a member of our Board of Directors, beneficially owned 13.57% of the ordinary shares outstanding and Roy Zisapel, our Chief Executive Officer, President and director, and Mr. Yehuda Zisapel's son beneficially owns approximately 5.18% of our ordinary shares outstanding (See "Item 6 - Share Ownership"). As a result, these shareholders may exert significant influence in the outcome of various actions that require shareholder approval, such as the election of our directors, and the approval or rejection of a merger and similar corporate transactions.

If we are characterized as a passive foreign investment company, our U.S. shareholders may suffer adverse tax consequences.

Generally, if for any taxable year 75% or more of our gross income is passive income, or at least 50% of our assets are held for the production of, or produce, passive income, we would be characterized as a passive foreign investment company, or PFIC, for U.S. federal income tax purposes. This characterization could result in adverse U.S. tax consequences to our U.S. shareholders, including having gain realized on the sale of our ordinary shares treated as ordinary income, as opposed to capital gain income, and having potentially punitive interest charges apply to such sales proceeds. U.S. shareholders should consult with their own U.S. tax advisors with respect to the U.S. tax consequences of investing in our ordinary shares.

We reasonably believe we were not a PFIC for our 2006 tax year. It is possible that the Internal Revenue Service will attempt to treat us as a PFIC for 2006 or prior years. The tests for determining PFIC status are applied annually and it is difficult to make accurate predictions of future income and assets, which are relevant to this determination. Accordingly, there can be no assurance that we will not become a PFIC in 2007 or in subsequent years. For a discussion of the rules relating to passive foreign investment companies and related tax consequences, please see the section of this annual report entitled “Item 10 - Additional Information - Taxation — United States Federal Income Tax Considerations.”

Risks Related to Operations in Israel

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

We are incorporated under Israeli law and our principal offices and manufacturing and research and development facilities are located in Israel. Accordingly, our operations and financial results could be adversely affected if political, economic and military events curtailed or interrupted trade between Israel and its present trading partners or if major hostilities involving Israel should occur in the Middle East.

Since the establishment of the State of Israel in 1948, a number of armed conflicts have taken place between Israel and its Arab neighbors. A state of hostility, varying in degree and intensity, has led to security and economic problems for Israel. Since October 2000, there has been a high level of violence between the Palestinians and Israel, which has strained Israel’s relationship with its Arab citizens, Arab countries and, to some extent, with other countries around the world. The establishment in early 2006 of a government in the Palestinian Authority by representatives of the Hamas militant group created additional unrest and uncertainty in the region. In July and August 2006, an armed conflict has taken place between Israel and Hezbollah, an Islamic movement based in Lebanon, which included the firing of multiple rockets by Hezbollah throughout northern Israel as well as retaliatory attacks by Israel throughout Lebanon.

We do not believe that the political and security situation has had a material impact on our business to date, however, there is no assurance that this will always be the case in the future. We could be adversely affected by any major hostilities, including acts of terrorism or any other hostilities involving or threatening Israel, the interruption or curtailment of trade between Israel and its trading partners or a significant downturn in the economic or financial condition of Israel. Furthermore, several countries restrict business with Israel and Israeli companies, and additional countries or companies may restrict doing business with Israel and Israeli companies as the result of the aforementioned hostilities. No predictions can be made as to whether or when a final resolution of the area’s problems will be achieved or the nature thereof and to what extent the situation will impact Israel’s economic development or our operations.

Some of our directors and officers as well as many of our Israeli employees are obligated to perform annual military reserve duty in Israel. We cannot assess the potential impact of these obligations on our business.

Some of our directors, officers and employees are, unless exempt, obligated to perform annual military reserve duty, depending upon their age and prior position in the army. They may also be further subject to being called to active duty at any time under emergency circumstances. Directors, officers, and key employees falling within these requirements include Roy Zisapel, our Chief Executive Officer and President, Amir Peles, our Chief Technical Officer, and Yuval Pemper, our Vice President, Research and Development. Our operations could be disrupted by the absence, for a significant period, of one of more of these officers or other key employees due to military service, and any disruption in our operations would harm our business. The full impact on our workforce or business if some of our officers and employees will be called upon to perform military service, especially in times of national emergency, is difficult to predict.

The rate of inflation in Israel and the change in the exchange rate between the New Israeli Shekel against the U.S. dollar and/or the U.S. dollar against the Euro is volatile, and may negatively impact our costs.

Most of our revenues are denominated in U.S. dollars or are dollar-linked, but we incur a portion of our expenses, principally salaries and related personnel expenses, in other currencies mainly in Israel, in New Israeli Shekels (“NIS”) and in Europe, in Euros. In 2006, we sold in Euros in most European countries. In this respect, we are exposed to the following risks: the rate of inflation in Israel may exceed the rate of devaluation of the NIS in relation to the dollar, the timing of this devaluation may lag behind inflation in Israel, or the NIS may increase in value relative to the dollar. In such events, the dollar cost of our operations in Israel will increase and our dollar-measured results of operations will be adversely affected. In addition, if the Euro increases in value relative to the dollar and sales in Euros do not exceed expenses incurred in Euros, the dollar cost of our operations in Europe will increase and our operating profit will be adversely affected. If the Euro decreases in value relative to the dollar and sales in Euros exceed expenses incurred in Euros, our operating profit will be negatively affected as a result of a decrease in the dollar value of our sales. In 2006, the value of the dollar decreased in relation to the NIS by 8.2%, the inflation rate in Israel was -0.1%, and the value of the dollar decreased in relation to the Euro by 10.2%. As a result, during 2006, we had an increase in expenses (as a result of the increase in the Euro exchange rate relative to the dollar), which was offset by the increase we had in our sales due to the fact that our sales to the EU countries are also denominated in Euro. We cannot provide assurances that we will not be materially adversely affected by the rate of inflation in Israel or exchange rate fluctuations in the future.

The tax benefits we may receive in connection with our approved enterprise program require us to satisfy prescribed conditions and may be terminated or reduced in the future. This would increase taxes and decrease our net profit

The Investment Center has granted us an approval to establish an “Approved Enterprise” program at our Tel Aviv and Jerusalem facilities. An Approved Enterprise is eligible for tax benefits on taxable income derived from its Approved Enterprise programs. The benefits available to an Approved Enterprise are dependent upon the fulfillment of conditions stipulated in applicable law and in the certificate of approval. If we fail to comply with these conditions, in whole or in part, with respect to any Approved Enterprise program we establish, or if we voluntarily decide to cease the Approved Enterprise program, we may be required to pay additional taxes for the period in which we benefited from the tax exemption or reduced tax rates and we would likely be denied these benefits in the future. One criterion for establishing the level of tax benefits is the percentage of holdings by foreign (i.e. non-Israeli) investors in our shares. A decrease in the level of foreign investors’ holdings may increase our tax rate.

An amendment to the Investment Law, which was published on April 1, 2005 (the “Amendment") has changed certain provisions of the Investment Law. As a result of the Amendment, the Company is no longer obliged to obtain an Approved Enterprise status in order to receive the tax benefits previously available under the Alternative Benefits provisions, and therefore there is no need to apply to the Investment Center for this purpose (Approved Enterprise status remains mandatory for companies seeking grants). Rather, the Company may claim the tax benefits offered by the Investment Law directly in its tax returns, provided that its facilities meet the criteria for tax benefits set out by the Amendment. The Company is also granted a right to approach the Israeli Tax Authority for a pre-ruling regarding their eligibility for benefits under the Amendment. Tax benefits are available under the Amendment to production facilities (or other eligible facilities), which are generally required to derive more than 25% of their business income from export (referred to as a “Benefited Enterprise” under the Amendment). In order to receive the tax benefits, the Amendment states that the Company must make an investment in the Benefited Enterprise exceeding a minimum amount specified in the Law. Such investment may be made over a period of no more than three years ending at the end of the year in which the Company requested to have the tax benefits apply to the Benefited Enterprise (the “Year of Election”). Where the Company requests to have the tax benefits apply to an expansion of existing facilities, then only the expansion will be considered a Benefited Enterprise and the Company’s effective tax rate will be the result of a weighted combination of the applicable rates. In this case, the minimum investment required in order to qualify as a

Benefited Enterprise is required to exceed a certain percentage of the Company's production assets before the expansion.

Our approved program and tax benefits thereunder may not continue in the future at their current levels or at any level. The termination or reduction of these tax benefits would likely increase our taxes. The amount, if any, by which our taxes would increase will depend upon the rate of any tax increase, the amount of any tax benefit reduction, and the amount of any taxable income that we may earn in the future.

Provisions of Israeli law could delay, prevent, or make difficult, a change of control, thereby depressing the price of our ordinary shares.

Provisions of Israeli Corporate and tax law may have the effect of delaying, preventing or making an acquisition of our Company more difficult. For example, under the Companies Law, upon the request of a creditor of either party to a proposed merger, the court may delay or prevent the merger if it concludes that there is a reasonable concern that, as a result of the merger, the surviving company will be unable to satisfy the obligations of any of the parties to the merger. These provisions could cause our ordinary shares to trade at prices below the price for which third parties might be willing to pay to gain control over us. Third parties who are otherwise willing to pay a premium over prevailing market prices to gain control of us may be unwilling to do so because of these provisions of Israeli law. For additional information on this topic, see "Item 10B - Additional Information - Memorandum and Articles of Association - Mergers and Acquisitions under Israeli law."

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

We are incorporated under the laws of the State of Israel. Service of process upon us, our Israeli subsidiaries and affiliates, and our directors and officers named herein substantially all of whom reside outside the United States, may be difficult to obtain within the United States. Furthermore, because the majority of our assets and investments, and substantially all of our directors and officers are located outside the United States, any judgment obtained in the United States against us or any of them may not be collectible within the United States.

It may be difficult to assert U.S. securities law claims in original actions instituted in Israel. Israeli courts may refuse to hear a claim based on a violation of U.S. securities laws because Israel is not the most appropriate forum to bring such a claim. In addition, even if an Israeli court agrees to hear a claim, it may determine that Israeli law and not U.S. law is applicable to the claim. If U.S. law is found to be applicable, the content of applicable U.S. law must be proved as a fact, which can be a time-consuming and costly process. Certain matters of procedure will also be governed by Israeli law. There is little binding case law in Israel addressing these matters.

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

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

- The judgment was not obtained by fraud and does not conflict with any other valid judgment in the same matter between the same parties; and

- An action between the same parties in the same matter is not pending in any Israeli court at the time the lawsuit is instituted in the U.S. court.

ITEM 4. Information on the Company

History and Development of the Company

Radware Ltd. was organized in May 1996 as a corporation under the laws of the State of Israel, and commenced operations in April 1997. Our principal executive offices are located at 22 Raoul Wallenberg Street, Tel-Aviv 69710, Israel and our telephone number is 972-3-766-8666. Our website address is www.radware.com. *Information contained on our website does not constitute a part of this annual report.*

As of January 1, 1999, we established a wholly-owned subsidiary in the United States, Radware Inc., which conducts the sales and marketing of our products in the Americas and is our authorized representative and agent in the United States. The principal offices of Radware Inc. are located at 575 Corporate Dr., Lobby 2, Mahwah, NJ 07430 and its telephone number is 201-512-9771.

We also have several wholly owned subsidiaries world-wide handling local support and promotion activities.

For a discussion of our capital expenditures and divestitures, see “Item 5—Operating and Financial Review and Prospects - Liquidity and Capital Resources.”

Business Overview

General

We develop, manufacture and market Application Delivery and Network Security (“business-smart networking”) solutions that provide end-to-end availability, performance and security of mission critical networked applications. Radware’s integrated Application Front-End, Application Access and Network Security solutions enable enterprises and carriers to deliver their mission critical applications successfully between data centers and remote locations, over all critical points in the network.

Our Application Delivery and Network Security solutions enable customers to manage their network infrastructure, bypass systems failures, scale their application performance, and secure their Internet protocol (“IP”) traffic. Our products align network behavior with business process to improve productivity and extract the greatest value from investments in network infrastructures by intelligently distributing traffic within the network, optimizing the use of available network resources and protecting applications, networks and users at high speeds. Over the years, our products have won a number of awards for performance, including Network Computing Editor’s Choice, SC Magazine Recommended Buy Award, Network Computing Well-Connected, Internet World Best of Show, PC Magazine Editor’s Choice and Network Magazine Product of the Year. All of our products are Underwriters Laboratories (UL) compliant and our products have also achieved significant industry certification such as the Common Criteria Evaluation & Validation Scheme (CCEVS) EAL 3 through the National Security Agency (NSA) program and FIPS 140-2 through the National Institute of Standards (NIST). In addition, we have been recognized as among the top industry players in our respective markets by independent, third-party IT analysts - for example, Forrester Research, Frost & Sullivan, Gartner, IDC, and Yankee Group.

In April 2007, we acquired Covelight, a U.S. based company, which provides web channel intelligence technology that allows business events to be captured in real-time on the network. This strategic move is intended to increase the market relevance of our APSolute product portfolio by moving from the "application-smart" approach to a new, more business-centric approach, which we position as "business-smart networking".

Products, Operating System (OS), Management Tool, Platforms, and Subscription Services

Radware sells application delivery and network security products ("devices") that run different configurations of software to deliver features specific to the intended operation of the appliance. These products utilize the proprietary APSolute OS (operating system), which embeds common operating logic into each product. Multiple Radware devices can be managed through the APSolute OS common management tool and dashboard (Insite) and are delivered via hardware switching platforms (AS1 - AS5) with various levels of processing power, throughput, port density, and speed depending on selected model. In addition, Radware offers a security update subscription service. Its products, operating system, management tools, switching platforms, and subscription services are all marketed under the APSolute brand.

Products (APSolute Product Suite)

The APSolute™ product suite consists of the following product families:

· *AppDirector™ Intelligent Application Delivery Controller* for data center optimization with advanced Layer 4-7 policies and granular packet classification to eliminate traffic surges, server bottlenecks, connectivity disconnects and downtime for ensured business continuity.

· *AppXcel™) Application Accelerator* performs web compression and Hypertext Transfer Protocol (HTTP) multiplexing, and accelerates web applications for high performance content serving and Secure Sockets Layer ("SSL") encryption and decryption, providing secure and effective SSL processing.

· *LinkProof®* manages Internet traffic for networks, commonly referred to as multi-homed networks, which access the Internet through multiple connections via several Internet Service Providers, to provide fault tolerant and cost effective Internet connectivity.

· *LinkProof® Branch* manages the operation of multiple links across all remote office links, allowing large, multi-branched enterprises to control and reduce the costs of their connectivity and Virtual Private Networks (VPN) between headquarters and branch offices.

· *DefensePro®* Intrusion Prevention and Denial of Service products protect against worms, bots, viruses, malicious intrusions and Denial of Service attacks at up to 6-Gigabit speeds, preventing attacks in real-time for intrusion prevention and multi-layer application defense.

· *SecureFlow™* simplifies the management and optimizes performance of best of breed enterprise security tools t*o* enable transparent, selective integration of content inspection, anti-virus, VPN, Intrusion Detection Systems (IDS) and firewalls into a unified switched architecture to eliminate the security/performance tradeoff.

· *Inflight™* delivers real-time business events to backend analytic engines (e.g. enterprise fraud, compliance, business intelligence, marketing, etc.) by performing passive identity-based monitoring of critical web channel application transaction activity. With Inflight, companies can optimize their business processes, offer new products and services on-the-fly to customers, and halt identity theft or fraudulent online behavior

· *CID - Content Inspection Director®* managed service delivery platform for carriers that enables centralized and optimized IP value added service deployment. With Content Inspection Director, carriers can extend high-performance security and media services to customers, customizing delivery, guaranteeing SLAs and generating a new source of revenues.

Operating System (APSolute OS)

APSolute OS is a modular operating system built around Radware's core software engines, the Application Classifier and Flow Manager that are used to classify traffic based on an extensive and granular set of application intelligence. Users can define classes of traffic and policies for how network resources should handle that traffic based on any combination of network, application, content and user information. APSolute OS service modules (each as described below), which are available on our hardware products, include: Advanced Health Monitoring, Traffic Redirection, Bandwidth Management, Application Acceleration, Intrusion Prevention and DoS Protection. With APSolute OS, enterprises and carriers can address existing and emergent application service requirements across server farms, security and connectivity layers.

· *APSolute OS Application-Smart Classification and Flow Management*

Radware's innovative APSolute OS features a unique classification and flow management engine that is used to classify traffic based on the industry's most extensive and granular set of application intelligence. Users can define classes of traffic and policies for how network resources should handle that traffic based on any combination of network, application, content and user information. APSolute OS tracks the flow of traffic end-to-end and implements multi-step decisions at every critical point across the transaction path to ensure optimized application delivery.

· *APSolute OS Health Monitoring and Failure Bypassing*

APSolute OS Health Monitoring continuously checks all network resources detecting failures in real-time and automatically redirecting traffic to the highest performing resources to bypass failures and guarantee high application availability and continuous operations.

· *APSolute OS Traffic Redirection*

APSolute OS Traffic Redirection intelligently distributes traffic across network devices to optimize the utilization of local and global resources, and ensure service availability and redundancy. APSolute OS Traffic Redirection enables maximum utilization of IT infrastructure capacities across farms, local and global sites using an extensive array of traffic redirection algorithms to dispatch traffic including cyclic distribution, least users, least packets and least bytes.

· *APSolute OS Bandwidth Management*

APSolute OS Bandwidth Management extends granular classification and control over bandwidth resource allocation, prioritizing all network traffic and guaranteeing service levels for mission critical applications across the entire network (with TOS and Diffserv marking).

· *APSolute OS Application Acceleration*

The APSolute OS advanced Layer 4-7 application acceleration technologies include: SSL offloading, Transmission Control Protocol (TCP) optimization, caching and reverse proxy, HTTP compression and advanced image and content compression.

· *APSolute OS Intrusion Prevention*

Automatically secures application network resources by continuously monitoring and inspecting all network traffic including SSL traffic, APSolute OS Intrusion Prevention immediately terminates suspicious sessions by implementing user/application/ content policies to completely safeguard applications. On-the-fly SSL inspection and IP reassembly provide an additional layer of protection against hacker evasion techniques.

· *APSolute OS DoS Protection*

Identifies and stops debilitating Denial of Service (DoS), Distributed Denial of Service (DDoS), and Structured Query Language (SQL) injections and protocol/traffic anomalies, protecting the network from service failures and downtime. Using advanced technologies including behavior-based analysis, APSolute OS DoS Protection automatically detects abnormal requests and thwarts network attacks before they undermine server operations, all the while ensuring secure traffic operations for uninterrupted service continuity.

Management Tool (APSolute Insite)

The common application management tool which runs across all Radware products is APSolute Insite. APSolute Insite is a unified management tool with an intuitive Graphical User Interface (GUI) that provides end-to-end network visibility, control and policy management of all application switching devices.

Based on an easy-to-use site map interface, APSolute Insite lets users draw their network, configure Radware Application-smart switching devices and set-up the APSolute OS Services (as described above) to address end-to-end IP application service requirements. APSolute Insite's statistics module provides real-time and historical views of actual application performance levels for monitoring site-wide operations and simple pinpointing of vulnerabilities and failures, affording complete visibility and control over the performance of Web and Application Servers, security tools, cache servers, anti-virus tools and Internet links. Based on this information, network administrators can decide to add resource capacities, tune bandwidth policies or relocate devices to better manage actual traffic loads and IP application performance requirements. Insite is also offered as a standalone network device under the Insite ManagePro label.

Application Switch Platforms

All Radware products are powered by our Application Switch platforms. Radware purpose-built Application Switching hardware offers scalable and flexible throughput performance to meet the broad range of enterprise and carrier end-to-end application delivery requirements.

Radware's Application Switch 1 combines ASIC-based switching, CPU processing power and APSolute OS Services to deliver the performance and service breadth to address all IP application requirements across network layers 4-7. Designed to guarantee application availability, security and performance, Application Switch 1 bridges the gap between IT infrastructure and IP Applications for comprehensive control of all critical operations across the enterprise.

Application Switch 2 is powered by a multi-layered switching architecture designed to address the widest set of protocols and service requirements across network layers 4-7 while boosting IP application performance to Gigabit Speeds. Delivering accelerated processing speeds with the ability to optimize routing decisions based on specific applications, web requests and content, Application Switch 2 provides reliability, performance and security across IP applications, for complete control over enterprise operations.

Application Switch 3 is a 3-tier processing architecture designed to meet the high capacity processing requirements for the most intensive layer 4-7 switching operations. Dual network processors in the second tier of the Application Switch 3 architecture, accelerate traffic redirection, load-balancing, quality of service control, real-time intrusion prevention and DoS mitigation for application security to multi-Gigabit speeds. The third-tier in the Application Switch 3 architecture is the powerful RISC processor that is responsible for managing and prioritizing all active application sessions.

Application Switch 4 is a three-tier processing architecture designed to meet the high capacity processing requirements for the most intensive intelligent application switching operations. Application Switch 4 features 44Gb connectivity, multi-Gigabit network processors and a strong 1.3-GHZ CPU. Driving application switching performance to up to 3-Gigabit speeds, AS4 affords complete control over mission critical applications and explosive transactions across the most demanding networking environments.

In 2006, we introduced our latest high-end platform for large enterprises and carriers, Application Switch 5, which doubles the throughput capacity of Application Switch 4 released in 2005. Application Switch 5 features an 88Gb

switching backbone, multi-Gigabit network processors, strong 1.7-GHZ CPU and a dual power supplies to provide the industry’s fastest Layer 7 performance and highest port density. We are also offering a new switch for our entry-level DefensePro® IPS/DoS x02 model series, the Security Platform 1.

Our products are compatible with any system that uses the Internet protocol and can operate with various network structures, configurations and operating systems. Our products support a wide variety of IP-based applications, including web services, e-mail, voice, P2P, Enterprise Resource Planning (ERP), Customer Relationship Management tools, database and file transfers.

Security Update Service

The Security Update Service, available as an optional subscription service, consists of Periodic Updates, Emergency Updates, and Custom Filters, which are supported by a Security Operations Center (Vulnerability & Exploit Detection; Security Risk Assessment, and Threat Mitigation). The service provides immediate and ongoing security updates to protect customers against the latest threats.

Customers and End-Users

With the exception of our limited direct sales efforts to select customers, we sell our products through distributors or resellers who then sell our products to end users.

We have a globally diversified end-user base, consisting of corporate enterprises including banks, insurance companies, manufacturing and retail, government agencies, media companies and service providers, such as telecommunication carriers, Internet service providers and application service providers. Customers in these different vertical markets deploy Radware for availability, performance and security of their applications from headquarters to branch offices.

In 2006, approximately 34% of our sales were in the Americas (principally in the United States), 34% were in EMEA (Europe, Middle East and Africa) and 32% in Asia-Pacific. Other than the United States, no single country accounted for more than 10% of our sales for 2006.

For the years ended December 31, 2006, 2005 and 2004, one single customer (a distributor) accounted for 12%, 16% and 11% of our sales, respectively. As of December 31, 2006 and 2005, no single customer represented more than 10% of the trade receivables balance.

Sales and Marketing

Sales. We market and sell our products primarily through an indirect sales channel that consists of distributors and resellers located in North America, Europe and Asia. In addition, we generate direct sales to select customers. Our sales channels are supported by our sales managers who are also responsible for recruiting potential distributors and resellers and for initiating and managing marketing projects in their assigned regions. The sales managers are supported by our internal sales support staff that help generate and qualify leads for the sales managers. As of December 31, 2006, we employed a total of 38 sales managers and sales staff in the Americas with locations in various states. We also employed 70 sales managers and sales staff based in the rest of the world, who are responsible for developing and maintaining distribution channels outside the Americas. We have subsidiaries and representative offices and branches in several countries, which promote and market our products and provide customer support in their respective regions.

Marketing Strategy. Our marketing strategy is to enhance brand recognition and maintain our reputation as a provider of technologically advanced, quality Application Delivery and Network Security solutions. We seek to build upon our marketing and branding efforts globally to achieve greater worldwide sales. Our sales force and marketing efforts are principally directed at developing brand awareness and providing sales support to our distributors. We participate in major trade shows and offer support to our distributors who participate in regional trade shows and events. We also invest in web based and print advertising campaigns as well as a global media and public relations campaign. In

addition to our independent marketing efforts, we invest in joint marketing efforts with our distributors, value added resellers and other companies that have formed strategic alliances with us.

We have entered into co-marketing arrangements with companies in other complementary segments, including:

- Aladdin Knowledge Systems Ltd.;
- Avaya, Inc.;
- Aventail Corporation;

- BEA Systems, Inc.;
- BMC Software Inc.;
- CA, Inc.;
- Finjan Software;
- Hewlett Packard Company;
- IBM, Inc.;
- Microsoft Corporation;
- Oracle Corporation; and
- SAP AG.

Strategic Alliances and Original Equipment Manufacturer Agreements. We have entered into strategic alliances and original equipment manufacturer agreements with other software and hardware vendors, including Forum Systems, Inc. and Imperva, Inc. as well as mutual channel information sharing arrangements. We believe that these companies have significant customer relationships and offer products which complement our products. The products are branded with the names of these companies or co-branded with our name. These agreements are standard distributor agreements, purchase agreements, OEM (original equipment manufacturer) agreements or other specific agreements and are terminable by either party at will. We plan to further invest in the development of strategic alliances in order to provide greater access to our target markets and enhance our brand name.

Technical Management

Our technical team, which consists of 110 employees worldwide as of December 31, 2006, supports our sales force during the sales process, assists our customers and distributors with the initial installation, set-up and ongoing support of our products, trains distributors and customers to use our products and provides software updates and product upgrades for our products. In addition, our technical team trains and certifies our distributors to provide limited technical support in each of the geographical areas in which our products are sold, and is directly responsible for remote support. Our Certainty Support Program provides offerings which allow customers to automatically get new software versions of their products and obtain optimized performance by purchasing any of the following five optional offerings: extended warranty, software updates, 24x7 help-desk (directly to our customers and through our distributors), on-site support and unit replacement.

Research and Development

In order to maintain our share of the Application Switching market, we place considerable emphasis on research and development to expand the capabilities of our existing products, develop new products and improve our existing technologies and capabilities. We believe that our future success will depend upon our ability to maintain our technological expertise, enhance our existing products and introduce, on a timely basis, new commercially viable products that will continue to address the needs of our customers. Accordingly, we intend to continue devoting a significant portion of our personnel and financial resources to research and development. In order to identify market needs and to define appropriate product specifications, as part of the product development process we seek to maintain close relationships with current and potential distributors, customers and vendors in related industry segments.

As of December 31, 2006, our research and development staff consisted of 163 employees. Research and development activities take place at our facilities in Israel. We employ established procedures for the requirement management, development and quality assurance of our new product developments. Our research and development organization is divided according to our existing products. Each product group is headed by a group leader and includes team leaders and engineers. In addition, we have a hardware and platform software department responsible for the development of the Radware hardware platforms and platform software, which are the basis for all products, serving all product groups, which consists of a senior group leader, group leaders, team leaders, and engineers. We also have an application infrastructure software group responsible for the software which is common to all our products (such as

the management tools), which consists of a group leader, team leaders and engineers. We furthermore have a quality assurance department, which assists all product groups, and includes a QA director, group leaders, team leaders and quality control engineers and technicians.

We occasionally use third-party subcontractors for the development of portions of research and development projects.

Manufacturing and Suppliers

USR Technologies and Electronics (2003) Ltd. (“USR”) manufactures most of the circuit boards which are the principal hardware component used in our products. It supplies us with finished circuit boards for final assembly. The other components and subassemblies included in our products are supplied to USR from a limited group of suppliers and subcontractors. USR monitors each stage of the circuit board production process, including the selection of components and subassembly suppliers. USR is ISO 9002 certified, indicating that its manufacturing processes adhere to established quality standards.

We install our proprietary software onto the circuit boards we receive from USR. Quality assurance testing, final assembly and packaging and shipping operations are primarily performed at our facility in Jerusalem, Israel.

These circuit boards are the principal component which we use in the manufacture of our products. If we are unable to acquire circuit boards from USR on acceptable terms, or should USR cease to supply us with circuit boards for any reason, we may not be able to identify and integrate an alternative source of supply in a timely fashion or at the same costs. Any transition to one or more alternate suppliers would likely result in delays, operational problems and increased costs, and may limit our ability to deliver our products to our customers on time for such transition period. We entered into agreements with two additional suppliers, but to date have only purchased relatively small quantities from those suppliers. If we would need to rely on the alternate suppliers, there is no assurance that we will be able to obtain the quantities we require at lead times and pricing competitive to USR.

Our activities in Europe require that we comply with European Union Directives with respect to product quality assurance standards and environmental standards.

Proprietary Rights

We rely on patent, trademark and trade secret laws, as well as confidentiality agreements and other contractual arrangements with our employees, distributors and others to protect our technology. We have a policy that requires our employees to execute employment agreements, including confidentiality and non-compete provisions.

We have registered trademarks for “Web Server Director®,” “Cache Server Director®”, “FireProof®”, “LinkProof®”, “Triangulation®”, “Smart Nat®”, “Get Certain®”, “CertainT®”, “Peer Director®”,“Synapps Architecture®”, “DefensePro®”, “StringMatch Engine®” and “CID - Content Inspection Director®” and we have trademark applications pending for “UpLink™”, “Radware™”, “APSolute”™, “AppDirector”™, “AppXCel”™ , “SecureFlow”™, “SOADirector”™, “SOASwitch”™, “SI “DFI- Deep Flow Inspection”™. We do not currently own any registered copyrights. We have registered patents in the United States for our triangle redirection method used for the global load balancing, for our mechanism for efficient management and optimization of multiple links used in our LinkProof product, for our method for load balancing by global proximity used in our WSD product and for our method for controlling traffic on links between autonomous BGP systems. We have pending patent applications and provisional patents in connection with several methods and features used in our products. These applications may not result in any patent being issued, and, if issued, the patents may not provide adequate protection against competitive technology and may not be held valid and enforceable if challenged. In addition, other parties may assert rights as inventors of the underlying technologies, which could limit our ability to fully exploit the rights conferred by any patent that we receive. Our competitors may be able to design around any patent we receive and other parties may obtain patents that we would need to license or circumvent in order to exploit our patents.

The protective steps we have taken may be inadequate to deter misappropriation of our technology and information. We may be unable to detect the unauthorized use of, or take appropriate steps to enforce, our intellectual property

rights. Some of the countries in which we sell our products do not protect intellectual property to the same extent as the United States and Israel. In addition, our competitors may independently develop technologies that are substantially equivalent or superior to our technology. Any licenses for intellectual property that might be required for our services or products may not be available on reasonable terms.

Competition

The Application Delivery and Network Security markets are highly competitive and we expect competition to intensify in the future. We may lose market share if we are unable to compete effectively with our competitors. Our principal competitors in the Application Delivery solutions market include: F5 Networks, Inc., Cisco Systems, Inc., Citrix Systems, Inc. Foundry Networks, Inc., and Juniper Networks, Inc. In addition, we face competitors in the Network Security space, with respect to our Intrusion Prevention Systems (IPS). Such principal competitors include Juniper Networks, Inc., 3Com Systems, Inc. (TippingPoint), McAfee, Inc., Sourcefire, Inc., and IBM Corporation (Internet Security Systems), We expect to continue to face additional competition as new participants enter the market. Larger companies with substantial resources, brand recognition and sales channels may form alliances with or acquire competing Application Delivery or Network Security solutions and emerge as significant competitors. For example, IBM Corporation became a competitor in the Network Security market by acquiring Internet Security Systems (ISS). Competition may result in lower prices or reduced demand for our products and a corresponding reduction in our ability to recover our costs, which may impair our ability to maintain and increase profitability. Furthermore, the dynamic market environment, which is demonstrated by the above acquisitions, poses a challenge in predicting market trends and expected growth.

We believe that our success will depend primarily on our ability to provide more technologically advanced and cost-effective Application Delivery and Network Security solutions, and more responsive customer service and support, than our competitors. However, we cannot assure you that the products we offer will compete successfully with those of our competitors. Furthermore, should competition intensify, we may have to reduce the prices of our products which will negatively impact our business and financial condition.

Israeli Office of Chief Scientist

From time to time, eligible participants may receive grants under programs of the Office of the Chief Scientist of the Israeli Ministry of Industry, Trade and Labor, or the Chief Scientist. Grants received are generally repaid through a mandatory royalty based on revenues from the sale of products (and ancillary services) incorporating know-how developed, in whole or in part, with the grants. This governmental support is conditioned upon the participant’s ability to comply with certain applicable requirements and conditions specified in the Chief Scientist’s program and with the provisions of the Law for the Encouragement of Research and Development in the Industry, 1984, and the regulations promulgated thereunder, or the Research and Development Law. Under the Research and Development Law, research and development programs that meet specified criteria and are approved by the Research Committee of the Chief Scientist are eligible for grants usually of up to 50% of certain approved expenditures of such programs, as determined by said committee. In exchange, the recipient of such grants is required to pay the Chief Scientist royalties from the revenues derived from products incorporating know-how developed within the framework of each such program or derived therefrom (including ancillary services in connection therewith), up to an aggregate of 100% of the dollar-linked value of the total grants received in respect of such program, plus interest.

The Israeli government is currently in the process of formulating a proposed amendment to the royalty regulations promulgated under the Research and Development Law. The amendment is expected to include changes to the royalty rates, which would vary from company to company based on the amount of its revenues and approval date of its program, up to a rate of 6%, and, as of 2006, to increase the rate of interest accruing on grants by 1% per year. The amendment was expected to have retroactive effect from January 1, 2006, although there is no assurance as to whether and when it will be adopted. The Research and Development Law generally requires that the product developed under a program be manufactured in Israel. However, upon notification to the Chief Scientist, up to 10% of the manufacturing volume may be performed outside of Israel; furthermore, upon the approval of the Chief Scientist, a greater portion of the manufacturing volume may be performed outside of Israel, provided that the grant recipient pays royalties at an increased rate, which may be substantial, and the aggregate repayment amount is increased up to 300% of the grant, depending on the portion of the total manufacturing volume that is performed outside of Israel. The

Research and Development Law further permits the Chief Scientist, among other things, to approve the transfer of manufacturing rights outside Israel in exchange for an import of different manufacturing into Israel as a substitute, in lieu of the increased royalties. The Research and Development Law also allows for the approval of grants in cases in which the applicant declares that part of the manufacturing will be performed outside of Israel or by non-Israeli residents and the Research Committee is convinced that doing so is essential for the execution of the program. This declaration will be a significant factor in the determination of the Chief Scientist whether to approve a program and the amount and other terms of benefits to be granted. For example, the increased royalty rate and repayment amount will be required in such cases.

By December 31, 2001, we repaid by way of royalties the full amount we owed to the Chief Scientist. In 2004, we applied, together with another company, to obtain a grant from the Chief Scientist under the "joint R&D project" track. The Chief Scientist approved the maximum grant to the project of approximately $0.2 million. In 2005, we applied to obtain an additional grant from the Chief Scientist, under the same project. The Chief Scientist approved an additional grant to the project in an additional maximum amount of approximately $0.2 million. During 2005 and 2006 we have received an aggregate amount of $0.4 million for this project from the Chief Scientist.

The Research and Development Law also provides that know-how developed under an approved research and development program may not be transferred to third parties in Israel without the approval of the Research Committee. Such approval is not required for the export of any products resulting from such research or development. The Research and Development Law further provides that the know-how developed under an approved research and development program may not be transferred to third parties outside Israel, except in certain circumstances and subject to the Chief Scientist's prior approval. The Chief Scientist may approve the transfer of Chief Scientist-funded know-how outside Israel, generally in the following cases: (a) the grant recipient pays to the Chief Scientist a portion of the sale price paid in consideration for such Chief Scientist-funded know-how (according to certain formulas), or (b) the grant recipient receives know-how from a third party in exchange for its Chief Scientist-funded know-how, or (c) such transfer of Chief Scientist-funded know-how arises in connection with certain types of cooperation in research and development activities.

The Research and Development Law imposes reporting requirements with respect to certain changes in the ownership of a grant recipient. The law requires the grant recipient and its controlling shareholders and foreign interested parties to notify the Chief Scientist of any change in control of the recipient or a change in the holdings of the means of control of the recipient that results in a non-Israeli becoming an interested party directly in the recipient and requires the new interested party to undertake to the Chief Scientist to comply with the Research and Development Law. In addition, the rules of the Chief Scientist may require additional information or representations in respect of certain of such events. For this purpose, "control" is defined as the ability to direct the activities of a company other than any ability arising solely from serving as an officer or director of the company. A person is presumed to have control if such person holds 50% or more of the means of control of a company. "Means of control" refers to voting rights or the right to appoint directors or the chief executive officer. An "interested party" of a company includes a holder of 5% or more of its outstanding share capital or voting rights, its chief executive officer and directors, someone who has the right to appoint its chief executive officer or at least one director, and a company with respect to which any of the foregoing interested parties owns 25% or more of the outstanding share capital or voting rights or has the right to appoint 25% or more of the directors. Accordingly, any non-Israeli who acquires 5% or more of our ordinary shares will be required to notify the Chief Scientist that it has become an interested party and to sign an undertaking to comply with the Research and Development Law.

The Israeli authorities have indicated in the past that the government may further reduce or abolish the Chief Scientist grants in the future. Even if these grants are maintained, we cannot presently predict what would be the amounts of future grants, if any, that we might receive.

Organizational Structure

As of January 1, 1999, we established a wholly-owned subsidiary in the United States, Radware Inc., which conducts the sales and marketing of our products in America. We also have subsidiaries in Australia, France, Germany, the United Kingdom, Italy, Japan, Singapore, Korea, Canada, Switzerland and India. We have also established representative offices in China, Taiwan and Russia. All of our subsidiaries are wholly-owned. All our subsidiaries and branches promote and offer support for our products. In April 2007 we purchased Covelight Systems, Inc., a Delaware corporation, which develops and manufactures the APSolute Inflight product. Our subsidiaries include:

Name of Subsidiary	Country of Incorporation
Radware Inc.	New Jersey, United States of America
Radware UK Limited	United Kingdom
Radware France	France
Radware Srl	Italy
Radware GmbH	Germany
Nihon Radware KK	Japan
Radware Australia Pty. Ltd.	Australia
Radware Singapore Pte. Ltd.	Singapore
Radware Korea Ltd.	Korea
Radware Canada Inc.	Canada
Radware GmbH	Switzerland
Radware India Pvt. Ltd.	India
Covelight Systems, Inc.(*)	Delaware, United States of America

(*) Purchased during 2007

Yehuda Zisapel is a co-founder and shareholder of Radware. Yehuda Zisapel is also a member of the Board of Directors of Radware. Individually or together with his brother, Zohar Zisapel, he is also a founder, director and/or principal shareholder of several other companies which, together with Radware and our subsidiaries listed above are known as the RAD-Bynet Group. These corporations include:

AB-NET Communications Ltd.
BYNET Data Communications Ltd.
BYNET Electronics Ltd.
BYNET SEMECH (outsourcing) Ltd.
Bynet Software Systems Ltd.
Bynet System Applications Ltd.
Ceragon Networks Ltd.
Commex Technologies Ltd.
Packetlight Networks Ltd.
RAD-Bynet Properties and Services (1981) Ltd.
RADCOM Ltd.
RAD Data Communications Ltd.
WISAIR Inc.
Sanrad Inc.
RADLive Ltd.
RADView Software Ltd.
RADVision Ltd.
RADWIN Ltd.
RiT Technologies Ltd.
Silicom Ltd.

The group also includes several other holdings, real estate companies, biotech and pharmaceutical companies. The above list does not constitute a complete list of the investments of Messrs. Yehuda and Zohar Zisapel.

In addition to engaging in other businesses, members of the RAD-Bynet Group are actively engaged in designing, manufacturing, marketing and supporting data communications products, none of which currently compete with our products. Some of the products of members of the RAD-Bynet Group are complementary to, and may be used in connection with, our products. See also “Item 7 - Major Shareholders and Related Party Transactions - Related Party Transactions”.

Property, Plants and Equipment

Israel. Our headquarters and principal administrative, finance, research and development and marketing operations are located in approximately 48,420 square feet of leased office space in Tel Aviv, Israel. The lease expires in October 2007. The facilities are leased from affiliated companies owned by Messrs. Yehuda and Zohar Zisapel. For more information see - "Item 7 -Major Shareholders and Related Parties Transactions." We also lease office space in a nearby location in Israel, of which approximately 2,590 square feet are leased from the same related party and approximately 5,920 square feet are leased from an unaffiliated party.

We also sublease approximately 5,482 square feet of space in Jerusalem for our manufacturing facility from USR. The sublease with respect to 2,150 square feet expires in April 2009 and the sublease with respect to the remaining 3,332 square feet expires in December 2007.

The aggregate annual rent for the premises in Israel for 2006 was approximately $686,000.

Other locations. In the United States, we lease approximately 12,382 square feet in Mahwah, New Jersey from a company owned by Yehuda and Zohar Zisapel, which lease will expire in April 2010. We also lease 4,916 square feet from an unaffiliated party in Costa Mesa, California, which lease expired in March 2007 and is renewable on a month to month basis. We also lease 3,024 square feet in Dallas, Texas from an unaffiliated party, which lease expires in February 2009. In addition, we lease facilities for the operation of our subsidiaries and representative offices in several locations in the United States, Europe and Asia Pacific.

The aggregate annual rent for the premises in locations outside Israel in 2006 was approximately $1,262,000.

Outlook. We may need additional space if we expand our business. In the event that additional or substitute offices and facilities are required, we believe that we could obtain such offices and facilities at commercially reasonable rates.

ITEM 4A. UNRESOLVED STAFF COMMENTS

None.

ITEM 5. OPERATING AND FINANCIAL REVIEW AND PROSPECTS

General

Our discussion and analysis of our financial condition and results of operation are based upon our consolidated financial statements, which have been prepared in accordance with generally accepted accounting principles in the United States. Our operating and financial review and prospects should be read in conjunction with our financial statements, accompanying notes thereto and other financial information appearing elsewhere in this annual report.

We are a provider of integrated application delivery and network security solutions, assuring availability, performance and security of business critical networked applications. We began selling our products in 1997, and currently have local offices, subsidiaries or branches in 15 countries in Asia-Pacific, Europe and the Americas.

We sell mainly through sales channels such as resellers and distributors. Most of our direct sales are to strategic customers in the United States. The web channel intelligence technology acquired from Covelight Systems in April 2007 ("Inflight") will be sold under the existing APSolute product portfolio through primarily direct sales channels in the first phase and through resellers and distributors in subsequent phases.

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Most of our revenues are generated in U.S. dollars or are dollar-linked and the majority of our expenses are incurred in dollars and, as such, we use the dollar as our functional currency. Our consolidated financial statements are prepared in dollars and in accordance with U.S. GAAP.

Revenues. Our revenues are derived primarily from sales of our products and, to a lesser extent, from sales of post-contract customer support through our Certainty Support program and sales of a security subscription service the "Security Update Service" ("SUS"). We generally recognize product revenue when persuasive evidence of an arrangement exists, delivery has occurred, the fee is fixed or determinable, no further obligation exists and collectability is probable. Post-contract customer support and the SUS service, which represents mainly software update subscriptions, help-desk support and unit repairs or replacements, is recognized ratably over the contract period.

Cost of Sales. Cost of sales refers to both products and service revenues and consists primarily of the cost of circuit boards and other components required for the assembly of our products, salaries and related personnel expenses for those engaged in the final assembly and maintenance service of our products and other overhead costs. Most of our Cost of Sales expenses are not fixed costs and are directly related to our revenues.

Research and Development Expenses. Research and development ("R&D") expenses consist primarily of salaries and related personnel expenses, costs of subcontractors and prototype expenses related to the design, development, quality assurance and enhancement of our products, and depreciation of equipment purchased for the development and testing processes. All research and development costs are expensed as incurred. We believe that continued investment in research and development is critical to attaining our strategic product objectives and therefore we plan to invest additional resources in 2007 in expanding our R&D organization, including new hires and purchase of new and advanced testing and development equipment.

Marketing and Selling Expenses. Marketing and selling expenses consist primarily of salaries, commissions and related personnel expenses for those engaged in the sales and marketing of our products as well as the cost of operating the offices which are located outside Israel and are engaged in the promotion, marketing and support of our products, in addition to the related trade shows, advertising, promotions, web site maintenance and public relations expenses.

General and Administrative Expenses. General and administrative expenses consist primarily of salaries and related personnel expenses for executive, accounting and administrative personnel, professional fees (which include legal, audit, expenses related to the implementation of Section 404 of the Sarbanes-Oxley Act, and additional consulting fees), bad debt expenses and other general corporate expenses.

Amortization of stock-based compensation. Our expenses also included amortization of stock-based compensation, which is allocated among cost of sales, research and development expenses, marketing and selling expenses and general and administrative expenses, based on the division in which the recipient of the option grant is employed. The stock-based compensation is being amortized to operating expenses over the vesting period of the individual options.

On December 16, 2004, the Financial Accounting Standards Board ("FASB") issued Statement of Financial Accounting Standards ("SFAS") No. 123 (revised 2004), "Share-Based Payment" ("SFAS No. 123(R)"), which is a revision of SFAS No. 123. Generally, the approach in SFAS No. 123(R) is similar to the approach described in SFAS No. 123. However, SFAS No. 123 permitted, but did not require, share-based payments to employees to be recognized based on their fair values while SFAS No. 123(R) requires all share-based payments to employees to be recognized, as of the first quarter of 2006, based on their fair values. SFAS No. 123(R) also revises, clarifies and expands guidance in several areas, including measuring fair value, classifying an award as equity or as a liability and attributing compensation cost to reporting periods.

SFAS No. 123(R) permits public companies to adopt its requirements using one of two methods: (i) a “modified prospective” method in which compensation cost is recognized beginning with the effective date (a) based on the requirements of Statement SFAS No. 123(R) for all share-based payments granted after the effective date and (b) based on the requirements of SFAS No. 123 for all awards granted to employees prior to the effective date of SFAS No. 123(R) that remain unvested on the effective date; (ii) a “modified retrospective” method which includes the requirements of the modified prospective method described above, but also permits entities to restate based on the amounts previously recognized under SFAS No. 123 for purposes of pro forma disclosures either (a) all prior periods presented or (b) prior interim periods of the year of adoption.

We adopted the new statement effective January 1, 2006, using the “modified prospective” method. The adoption of SFAS No. 123(R) in 2006 resulted in operating expenses of $4.5 million and 24 cents loss per diluted share. The impact of SFAS 123(R) on our results of operations in future period may be affected by our stock price as well as assumptions regarding a number of complex and subjective variables and the related tax impact. These variables include, but are not limited to, the volatility of our stock price, expected forfeiture rate and employee stock option exercise patterns.

Financial Income (Expenses), Net. Financial income, net consists primarily of interest earned on short-term and long-term bank deposits, and of amortization of premiums, accretion of discounts and interest earned on investment in marketable securities of proceeds from the issuance of our shares to the public, from the exercise of options to purchase our shares, from cash generated from our operations and from income and expenses from the translation of monetary balance sheet items denominated in non-dollar currencies

Taxes, Israeli companies are generally subject to corporate tax on their taxable income at the rate of 31% for the 2006 tax year. Following an amendment to the Israeli Income Tax Ordinance [New Version], 1961 (the “Tax Ordinance”), which came into effect on January 1, 2006, the corporate tax rate is scheduled to decrease as follows: 29% for the 2007 tax year, 27% for the 2008 tax year, 26% for the 2009 tax year and 25% for the 2010 tax year and thereafter. Israeli companies are generally subject to capital gains tax at a rate of 25% for capital gains (other than gains deriving from the sale of listed securities) derived after January 1, 2003. However, we have established an approved enterprise program (the ”Program”), which is eligible for the tax benefits for operational profit, described below under the heading ”Corporate Tax Rate”. These benefits result in part of our income being tax exempt or taxed at a lower rate for some time after we begin to report taxable income. The tax rate depends upon the percentage of our income derived at that time from the Approved Enterprise program. The tax benefits depend on our meeting the requirements of the Program and there is no assurance we will be able to obtain such benefits. We have carry-forward capital losses for tax purposes and we anticipate to utilize these losses in 2007 and subsequent years. We have recorded a deferred tax asset in relation to these losses. Our U.S. subsidiary and two other subsidiaries have carry-forward tax losses to offset against future taxable profit. We have recorded a deferred tax asset in relation to these carry-forward tax losses and we anticipate that we will utilize part of these tax losses in 2007 and after. We have also recorded a valuation allowance in connection with these deferred tax assets. Other subsidiaries of ours are taxed according to the laws in their countries of incorporation and tax expenses are recorded accordingly. We may incur, for accounting purposes, tax expenses in 2007 which we anticipate to be at a rate of up to 10% of our operating income.

Market Trends. According to IT analyst estimations, the IT market in 2006 continued to grow slightly but at a lesser rate than 2005. In terms of geographical variances, the U.S. experienced less overall IT spending growth than Western Europe and Asia Pacific, with China and India reaching double-digit growth percentage levels. While networking equipment drove growth in IT spending in 2005, it reached mature market conditions in 2006 and therefore had a slower share of contribution to overall IT spending than in previous years. Due to the slowing rate of growth in the market it is difficult to predict the conditions of our market going forward. In addition, we believe that market conditions cause our customers and potential customers to be more conservative in planning their spending. If the global conditions deteriorate, and companies in our target markets continue to reduce capital expenditures, we may experience a reduction in sales, as well as downward pressure on the price of our products. In addition, if the market continues to be flat and customers continue to experience low visibility we may not be able to increase our sales. Each of the above scenarios would have a material adverse effect on our business, operating results and financial condition.

Furthermore, at the end of 2005 and throughout the course of 2006 several acquisitions took place in our space which resulted in continuous changes in the competitive landscape. F5 acquired Swan Labs in the third quarter of 2005 for WAN optimization capabilities. Citrix continued its acquisition pattern in 2006 following its NetScaler (application acceleration) and Terros (application firewall) acquisitions in 2005, by acquiring Reflectent Software (application performance monitoring) and Orbital Data (WAN Optimization). And, IBM became a competitor in the Intrusion Prevention space by acquiring Internet Security Systems (ISS) in August of 2006. The dynamic market environment,

which is demonstrated by the above acquisitions, poses a challenge in predicting market trends and expected growth.

We intend to continue our investment in the marketing and branding of our APSolute product family, in order to broaden market acceptance of such products. Such investment includes recruitment of skilled personnel, participation in trade shows, testing of our products by leading firms in the industry, investment in brand awareness and online advertising, and so forth. There is no assurance that we will be successful in such marketing and selling activities and that the increase in revenues, if any, will justify the investment.

Business Combinations. In December 2005, we acquired the business of V-Secure which included the acquisition of intellectual property, technology, customers relationship and goodwill. The initial consideration for the acquisition was $9,168,000, out of which an amount of $ 9,011,000 was paid in cash; and $148,000 was paid by issuance of fully vested warrants to V-Secure to purchase 45,454 ordinary shares of the Company. The remaining balance was related to acquisition costs payable. Additional cash consideration of $3,000,000 was paid as part of the purchase agreement during 2006 and V-Secure waived any claim or demand for additional payments. Accordingly, the total consideration for the acquisition amounted to $12,168,000.

The purchase price for the above acquisition was allocated to the identifiable intangible assets acquired (which have been valued by a third party valuation specialist) based upon their estimated fair values. The acquisition was accounted for under the purchase method of accounting. During 2006, no impairment loss was recorded in connection with the acquired intangible assets. See also Note 1e to our Consolidated Financial Statements included in this annual report.

In April 2007 we acquired Covelight Systems, Inc. (“Covelight”) by way of merger. The total consideration for this acquisition is up to $16 million, of which $7.5 million was paid in cash and an additional amount of up to $8.5 million, which is contingent upon sales performance targets, may be due by April 2008.

We have engaged a third-party valuation specialist to evaluate the identifiable assets of Covelight for the purpose of purchase price allocation. The financial statements for the second quarter of 2007 will reflect the acquisition.

Critical Accounting Policies

Our consolidated financial statements are prepared in accordance with U.S. GAAP. These accounting principles require management to make certain estimates, judgments and assumptions based upon information available at the time that they are made, historical experience and various other factors that are believed to be reasonable under the circumstances. These estimates, judgments and assumptions can affect the reported amounts of assets and liabilities as of the date of the financial statements, as well as the reported amounts of revenues and expenses during the periods presented.

In many cases, the accounting treatment of a particular transaction is specifically dictated in U.S. GAAP and does not require management’s judgment in its application. There are also areas in which management’s judgment in selecting among available alternatives would produce a materially different result. The Company’s management has reviewed these critical accounting policies and related disclosures with the Company’s Audit Committee. See Note 2 to our Consolidated Financial Statements, which contains additional information regarding our accounting policies and other disclosures required by U.S. GAAP.

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

- Revenue recognition;
- Accounting for doubtful accounts;

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- Inventory valuation;
- Goodwill and intangible assets valuation;
- Stock based compensation;
- Income taxes; and
- Legal contingencies.

Revenue Recognition. The Company and its subsidiaries generate revenues from selling their products and post-contract customer support primarily through distributors and resellers, all of which are considered as end-users. In North America (and rarely in the rest of the world), the Company also generates revenues from direct sales to select end users.

Revenues from product sales are recognized when delivery has occurred, persuasive evidence of an agreement exists, the fee is fixed or determinable, no further obligation exists and collectability is probable.

Revenues in arrangements with multiple deliverables are recognized under the "residual method" when Vendor specific objective evidence ("VSOE") of fair value exists for all undelivered elements, no VSOE exists for the delivered elements, and all other revenue recognition criteria are satisfied. VSOE for post-contract customer support is determined based on the price when it is sold separately in similar arrangements. The price may vary in the territories and vertical markets in which the Company conducts business. Price is determined by using a consistent percentage of the product price.

Revenue derived from post-contract customer support, which represents mainly software subscription, SUS and unit replacement and repair services, is recognized ratably over the contract period, which is typically one year.

Revenues from training and installation, which are considered as not essential to the functionality of the product, included in multiple elements arrangements are recognized at the time they are rendered. We do not have material revenues from training and installations.

The Company and its subsidiaries provide a provision for product returns and stock rotation based on their experience with historical sales returns, analysis of credit memo data and other known factors, in accordance with SFAS No. 48 "Revenue Recognition When Right of Return Exists". If the historical data used to calculate these estimates does not properly reflect future returns, additional provision for sales returns may be required, and revenues in that period could be adversely affected.

Deferred revenue includes unearned amounts received under post-contract customer support and SUS.

Accounting for Doubtful Accounts. Our accounts receivable are derived from our sales to our customers located all over the world. We perform periodic credit evaluations of our customers' financial condition. We maintain an allowance for doubtful accounts for estimated losses, which may result from the inability of our customers to make required payments. Management exercises judgment as to its ability to collect outstanding receivables. Allowances for doubtful accounts are made based upon a specific review of all significant outstanding invoices. For those invoices not specifically reviewed, allowances for doubtful accounts are made based upon the age of the receivable. In determining the allowance, we analyze our historical collection experience and current economic trends. If the historical data used to calculate the allowances for doubtful accounts do not reflect the future ability to collect outstanding receivables, additional allowances for doubtful accounts may be needed and the future results of operations could be materially affected.

Inventory Valuation. At each balance sheet date, we evaluate our inventory balance for excess quantities and obsolescence. This evaluation includes an analysis of sales levels by product and projections of future demand. In addition, we write off inventories that are considered obsolete. Remaining inventory balances are adjusted to the lower of cost or market value. If future demand for our old or new products, or market conditions are less favorable than our projections, additional inventory write-downs may be required and would be reflected in cost of sales for such period. During the first quarter of 2007 we performed an inventory write-off in an amount of $1.4 million in connection with the anticipated release of our new generation platforms.

Goodwill and Intangible assets. Goodwill represents excess of the costs over the fair value of net assets of businesses acquired. Under SFAS No. 142, goodwill is not amortized. SFAS No. 142 requires goodwill to be tested for impairment on adoption and at least annually thereafter or between annual tests in certain circumstances, and written down when impaired, rather than being amortized as previous accounting standards required. Goodwill is tested for impairment by comparing the fair value with its carrying value. Fair value is determined using discounted cash flows and market multiples. During the year ended December 31, 2006 no such impairment losses were recorded.

Intangible assets are amortized over their useful life using a method of amortization that reflects the pattern in which the economic benefits of the intangible assets are consumed or otherwise used up, in accordance with SFAS No. 142. Acquired technology and customer relationships are amortized using the straight-line method over an estimated period between six to ten years during which benefits are expected to be received. During 2006, an amount of $ 450,000 was recorded as amortization expenses, included in cost of revenues and sales and marketing expenses. As of December 31, 2006, no impairment losses have been identified.

Stock-based compensation. For a discussion of the accounting of stock-based compensation - see "Item 5 - Operating and Financial Review and Prospects - General - Amortization of stock-based compensation", and note 2n to the financial statements.

Income Taxes. We account for income taxes in accordance with SFAS No. 109, "Accounting for Income Taxes". This statement prescribes the use of the liability method whereby deferred tax assets and liability account balances are determined based on differences between financial reporting and tax bases of assets and liabilities and are measured using the enacted tax rates and laws that will be in effect when the differences are expected to reverse. We provide a valuation allowance, if necessary, to reduce deferred tax assets to their estimated realizable value if it is more likely than not that a portion or all deferred tax assets would not be realized.

In evaluating our ability to recover our deferred tax assets, we consider all available positive and negative evidence including our past operating results, the existence of cumulative losses in the most recent fiscal years and our forecast of future taxable income on a jurisdiction by jurisdiction basis. In determining future taxable income, we are responsible for assumptions utilized, the reversal of temporary differences and the implementation of feasible and prudent tax planning strategies. These assumptions require significant judgment about the forecasts of future taxable income and are consistent with the plans and estimates we use to manage the underlying business. We are in the process of evaluating the possible impact of the adoption of FASB Interpretation No. 48, "Accounting for Uncertainty in Income Taxes" ("FIN 48") - see "Impact of recently issued Accounting Policies" below.

Legal Contingencies. We are a party to a few litigation proceedings as described in "Item 8 - Financial Information - Legal Proceedings".

Impact of recently issued Accounting Standards

In June 2006, the FASB issued Interpretation No. 48, "Accounting for Uncertainty in Income Taxes" ("FIN 48"). FIN 48 creates a single model to address uncertainty in tax positions. FIN 48 clarifies the accounting for income taxes by prescribing the minimum recognition threshold a tax position is required to meet before being recognized in the financial statements. FIN 48 also provides guidance on de-recognition, measurement, classification, interest and penalties, accounting in interim periods, disclosure and transition. In addition, FIN 48 clearly scopes out income taxes from Financial Accounting Standards Board Statement No. 5, "Accounting for Contingencies." FIN 48 utilizes a two-step approach for evaluating tax positions. Recognition (step one) occurs when an enterprise concludes that a tax position, based solely on its technical merits, is more-likely-than-not to be sustained upon examination. Measurement (step two) is only addressed if step one has been satisfied (i.e., the position is more-likely-than-not to be sustained). FIN 48 applies to all tax positions related to income taxes subject to Financial Accounting Standards Board Statement No. 109, "Accounting for Income Taxes." This includes tax positions considered to be "routine" as well as those with a

high degree of uncertainty. De-recognition of a tax position that was previously recognized would occur when a company subsequently determines that a tax position no longer meets the more-likely-than-not threshold of being sustained. FIN 48 specifically prohibits the use of a valuation allowance as a substitute for derecognition of tax positions. FIN 48 is effective for fiscal years beginning after December 15, 2006. We are in the process of evaluating the possible impact of the adoption of FASB Interpretation No. 48, “Accounting for Uncertainty in Income Taxes” (“FIN 48”) – see “Impact of recently issued Accounting Policies” below

In September 2006, the FASB issued SFAS No. 157, "Fair Value Measurements" (“SFAS No. 157”). SFAS No. 157 defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles and expands disclosures about fair value measurements. SFAS No. 157 is effective for financial statements issued for fiscal years beginning after November 15, 2007 and interim periods within those fiscal years. We believe that SFAS No. 157 will not have a material effect on our consolidated financial statements.

In February 2007, the FASB issued SFAS No. 159, “The Fair Value Option for Financial Assets and Financial Liabilities” (“SFAS No. 159”), which permits companies to choose to measure certain financial instruments and other items at fair value that are not currently required to be measured at fair value. SFAS No. 159 is effective for fiscal years beginning after November 15, 2007. We will adopt SFAS No. 159 no later than January 1, 2008. We have not yet determined the effect that the adoption of SFAS No. 159 will have on our consolidated financial statements.

A. Operating Results

The following table sets forth, for the periods indicated, certain financial data expressed as a percentage of sales:

	Year ended December 31, 2002	Year ended December 31, 2003	Year ended December 31, 2004	Year ended December 31, 2005	Year ended December 31, 2006
Sales	100.0%	100.0%	100.0%	100.0%	100.0%
Cost of sales	18.2	18.0	17.8	19.2	19.4
Gross profit	81.8	82.0	82.2	80.8	80.6
Operating expenses:					
Research and development, net	17.9	15.3	15.1	16.8	21.7
Sales and marketing	68.7	54.3	46.6	51.5	61.6
General and administrative	9.7	7.6	6.6	6.8	7.6
Total operating expenses	96.3	77.2	68.3	75.1	90.9
Operating profit (loss)	(14.5)	4.8	13.9	5.7	(10.3)
Financial income, net	9.7	6.9	6.7	6.6	9.1
Income (loss) before income taxes	(4.8)	11.7	20.6	12.3	(1.2)
Income taxes	-	-	(0.5)	(0.3)	(0.4)
Minority interest in earnings of a subsidiary	-	(0.1)	-	-	-
Net income (loss)	(4.8)%	11.6%	20.1%	12.0%	(1.6)%

Geographical Distribution of Revenues

The Company operates in one reportable segment. Its total revenues are attributed to geographic areas based on the location of the end-users.

Following is the breakdown of the Company's total revenues by geographical distribution both in U.S. dollars and as a percentage of total revenues for the years ended December 31, 2004, 2005 and 2006:

	Year Ended December 31, 2004		**Year Ended December 31, 2005**		**Year Ended December 31, 2006**	
	(in thousands of U.S. $)	**(by percentage)**	**(in thousands of U.S. $)**	**(by percentage)**	**(in thousands of U.S. $)**	**(by percent-age)**
North, Central and South Americas (principally the United States)	28,984	42.4%	31,900	41.1%	27,646	34.0%
EMEA (Europe, the Middle East and Africa)	20,450	29.9%	24,074	31.0%	27,529	33.8%
Asia Pacific	19,005	27.7%	21,610	27.9%	26,235	32.2%

Breakdown of Total Revenues by Products and Services

The following table provides the breakdown of the Company's total revenues by products and services both in U.S. dollars and as a percentage of total revenues for the years ended December 31, 2004, 2005 and 2006:

	Year Ended December 31, 2004		**Year Ended December 31, 2005**		**Year Ended December 31, 2006**	
	(in thousands of U.S. $)	**(by percentage)**	**(in thousands of U.S. $)**	**(by percentage)**	**(in thousands of U.S. $)**	**(by percentage)**
Products	52,206	76.3%	55,902	72.1%	57,335	70.4%
Services	16,233	23.7%	21,682	27.9%	24,075	29.6%

Executive Summary - Year Ended December 31, 2006

Sales in 2006 were approximately $81.4 million, an increase of 5% compared with sales of $77.6 million in 2005. In 2006 we continued the trend of sequential increase in sales, year over year, since our inception. The cost of sales as percentage of revenues stayed approximately at the same level as it was in 2005. In order to continue to strengthen and broaden our product lines we have increased our investments in research and development during 2006, mainly increasing the manpower engaged in the development of our products. In order to increase market acceptance of our new products and to strengthen our branding and market penetration in certain regions, we increased our sales and marketing expenses throughout the year. Our sales increased at a lower rate than the increase of our operating expenses. As a result of the aforementioned, and as a result of the adoption of SFAS No. 123(R) for the first time in 2006, our operating results in 2006 reflected a loss of $8.3 million, compared to an operating profit of $4.4 million in

2005. The financial income increased due to the increase in our average cash balance throughout the year, due to the increase in interest rates and due to gains from foreign currency translation differences. Such differences resulted mainly from the increase in the value of the Euro relative to the Dollar during 2006.

In 2007 we intend to continue and increase investment in the development of new products and directions as well as in the improvement of existing products, to support continued growth in our sales and enhancement of market acceptance for our offerings, including in the branding and market penetration of the Covelight technology which become a part of our product suite starting May 2007. As a result our cost of sales, research and development and sales and marketing expenses are expected to increase compared to 2006. There is no assurance that our investment in new products and market penetration will increase our revenues and justify the additional expense.

Year Ended December 31, 2006 Compared with Year Ended December 31, 2005

Revenues. Sales in 2006 were approximately $81.4 million, including sales of products of $57.3 million and services revenue of $24.1 million, an increase of approximately 5% compared with sales of approximately $77.6 million in 2005 which included sales of products of $55.9 million and services revenue of $21.7 million. The increase in sales was comprised of an increase of 3% in products sales and an increase of 11% in services revenue. The increase in services revenue is attributed mainly to renewal of service contracts. During 2006 we moderately increased our sales compared to 2005 but less then we expected. We attribute this to a period of uncertainty in the market following some mergers and acquisition in our industry (such as Internet Security Systems (ISS by IBM and Reflectent Software and Orbital Data by Citrix) and due to changes in our Americas sales team that was restructured in the fourth quarter of 2006. During 2006 the portion of our sales in North America decreased to 34% of our sales, compared to 41% in 2005, which led to the reorganization at the end of the year.

Cost of Sales. Cost of sales was approximately $15.8 million in 2006, comprised of $10.3 million as cost of products sales and $5.5 million as cost of services revenue, compared with cost of sales of approximately $14.9 million in 2005 which was comprised of $9.3 million of cost of products sales and $5.6 million as cost of services revenue. Cost of products sales as a percentage of products sales was 17.9 % in 2006, compared to approximately 16.7% in 2005. As some of the products we offer have stronger performance, the manufacturing costs for these products are higher, but these higher costs are partially offset by higher sales prices charged to our customers. Cost of sales related to services revenues in 2006 was 22.9% compared to 25.7% in 2005. As a major portion of these costs are fixed costs (mainly salaries of technical personnel), the increase in sales did not translate into the same rate of costs increase. In addition, renewal service agreements require fewer resources and as the portion of the renewal support sales is increasing, the related costs are decreasing as a percentage of sales.

Research and Development Expenses. Research and development expenses were approximately $17.7 million in 2006, an increase of 36% compared with research and development expenses of approximately $13.0 million in 2005. The increase is primarily due to hiring of new R&D personnel, the increase in salary level needed to obtain high level personnel and the devaluation of the dollar against the NIS, due to the depreciation of R&D equipment purchased during 2006 and due to the increased use of subcontractors and consultants to assist with and promote certain R&D projects. Additional R&D employees were hired during 2006 in order to support the development of new platforms and products, including enhancement of our quality assurance department. All R&D salaries were paid in NIS. A material part of the increase (in an amount of $1.1 million) is also attributed to the adoption for the first time of SFAS No. 123(R) in 2006. We expect our R&D expenses to increase in 2007 due to the recruitment of additional personnel and salary increases of existing personnel.

Sales and Marketing Expenses. Sales and marketing expenses were approximately $50.1 million in 2006, an increase of 25% compared with sales and marketing expenses of approximately $40.0 million in 2005. Percentage-wise, the share of sales and marketing expenses of total revenues increased from 51.5% in 2005 to 61.6% in 2006. The increase of our sales and marketing expenses in 2006 is related to the continued investment in market acceptance of new products and our next generation APSolute product family, and investment in strengthening the sales teams in some of our offices in the U.S., Asia-Pacific and EMEA. The increase is also related to the adoption for the first time of SFAS No. 123(R) in 2006, which resulted in an additional expense of $2.5 million..We anticipate increasing sales and marketing expenses also in 2007 primarily for the purposes of (i) increasing brand awareness and market acceptance of our new products (by participation in trade shows and seminars, testing and certification of our products by leading firms in the industry and receiving top analysts coverage for our products and strategy); and (ii) strengthening our international presence (by adding sales and marketing personnel, as well as technical support personnel).

General and Administrative Expenses. General and administrative expenses were approximately $6.2 million in 2006, compared with general and administrative expenses of approximately $5.2 million in 2005. This increase is primarily due to the increase of salaries expenses which resulted from hiring of new personnel, salary adjustments, the devaluation of the U.S. dollar against the NIS (as most of the general and administrative salaries are paid in NIS) and the first adoption of SFAS No. 123(R) in 2006, which added an expense of approximately $0.8 million

Financial Income, Net. Financial income, net was approximately $7.4 million in 2006, an increase of approximately 42.3% compared with financing income, net of approximately $5.2 million in 2005. This increase is attributable to the increase in the average balance of our cash and cash equivalents, bank deposits and marketable securities during the year, before $11.1 million was invested in the buy-back of our shares, an increase in interest rates and gains from foreign currency translation differences.

Income Taxes. Income taxes were approximately a $0.4 million benefit in 2006 (in and outside Israel), compared to approximately a $0.2 million benefit in 2005. This amount derives mainly from current taxes and change in deferred taxes.

Year Ended December 31, 2005 Compared with Year Ended December 31, 2004

Revenues. Sales in 2005 were approximately $77.6 million, including sales of products of $55.9 million and services revenue of $21.7 million, an increase of approximately 13% compared with total sales of approximately $68.4 million in 2004 which included sales of products of $52.2 million and services revenue of $16.2 million. The growth in sales during 2005 is primarily attributable to the expansion of our sales and marketing activities, and a slight improvement in the market environment and corporate spending, as well as an increase resulting from sales of service renewal contracts related to the a larger installed units base.

Cost of Revenues. Cost of sales was approximately $14.9 million in 2005, comprised of $9.3 million as cost of product sales and $5.6 million as cost of services revenue, compared with cost of sales of approximately $12.2 million in 2004 which was comprised of $8.1 million of cost of products sales and $4.1 million as cost of services revenue. Cost of products sales as a percentage of products sales was 16.7 % in 2005, compared to approximately 15.5% in 2004. This increase is primarily attributable to the introduction of new products as well as a different mix of products. Cost of sales related to services revenues in 2005 was 25.7% compared to 25.3% in 2004.

Research and Development Expenses. Research and development expenses were approximately $13.0 million in 2005, an increase of 26% compared with research and development expenses of approximately $10.3 million in 2004. The increase is primarily due to hiring of new R&D personnel. Additional R&D employees were hired during 2005 in order to support our Application Delivery and Network Security capabilities and development of new platforms and products, including enhancement of our quality assurance department. A small part of the increase was offset due to the decrease in the U.S. dollar cost of our salaries for our research and development staff caused by the decrease in

value of the NIS against the dollar. All these salaries were paid in NIS.

Sales and Marketing Expenses. Sales and marketing expenses were approximately $40.0 million in 2005, an increase of 25% compared with sales and marketing expenses of approximately $31.9 million in 2004. Percentage-wise, the share of sales and marketing expenses of total revenues increased from 46.6% in 2004 to 51.5% in 2005. The increase of our sales and marketing expenses in 2005 is related to the increase in sales as well as the continued investment in market acceptance of new products and our next generation APSolute product family, and investment in new geographical markets, mainly in Europe and the Far East.

General and Administrative Expenses. General and administrative expenses were approximately $5.2 million in 2005, an increase of approximately 16.7% compared with general and administrative expenses of approximately $4.5 million in 2004. This increase is primarily attributable to the actions we have taken in order to improve our information systems and to professional services received in order to prepare our Company to comply with the Sarbanes-Oxley Act of 2002.

Financial Income, Net. Financial income, net was approximately $5.2 million in 2005, an increase of approximately 13% compared with financing income, net of approximately $4.6 million in 2004. This increase is attributable to the total increase in cash and cash equivalents, bank deposits and marketable securities and increase in interest rates which was partially offset by a loss from foreign currency translation differences which are included in financial income, caused mainly by a decrease in the value of the Euro relative to the dollar.

Income Taxes. Income taxes were approximately $0.3 million in 2005 (in and outside Israel), the same as in 2004. This amount derives mainly from current taxes and change in deferred taxes.

B. Liquidity and Capital Resources

In our opinion, the Company's working capital is sufficient for the Company's present requirements. Since our inception, we have financed our operations through a combination of issuing debt and/or equity securities, including two public offerings, research and development and/or marketing grants from the Government of Israel and cash generated by operations. We raised approximately $12.9 million in two private placements, in November 1997 and June 1999. In October 1999, we raised net proceeds of approximately $56.8 million in the initial public offering of our ordinary shares. In January 2000, we raised net proceeds to the Company of approximately $59.8 million in a public offering of our ordinary shares.

Capital expenditures for the years ended December 31, 2004, 2005 and 2006 were approximately $2.4 million , $3.6 million and $5.8 million, respectively. These expenditures were mainly comprised of machinery and equipment, computers, lab equipment and testing tools and ERP systems. During 2006 we invested in purchasing and implementing a new ERP system which became operational in the beginning of 2007. Additional investments related to the implementation of the ERP system and to the purchase and implementation of additional modules are expected to take place during 2007. We may have additional capital spending consistent with possible growth in our operations, infrastructure and personnel.

Net cash provided by operating activities was approximately $7.3 million for the year ended December 31, 2006, compared with $ 13.9 million for the year ended December 31, 2005 and $15.2 million for the year ended December 31, 2004. Net cash provided by operating activities for the years 2006, 2005 and 2004 changed primarily due to the changes in our operating profit and loss in these years, mainly as a result of the increase in operating expenses - which, for example, in 2006 and in 2005 exceeded the pace of increase in sales. Net cash provided by operating activities for 2006 consisted primarily of net loss plus amortization of stock based compensation, plus depreciation and amortization, plus increase in trade payables and deferred revenues, offset by an increase in trade receivables and in inventories. Net cash provided by operating activities for the year 2005 consisted primarily of net income plus an increase in deferred revenues and other payables and accrued expenses, offset by an increase in trade receivables and inventories. Net cash provided by operating activities for 2004 consisted primarily of net income plus an increase in deferred revenues, offset by an increase in trade receivables and inventories.

Net cash used in investing activities was approximately $39.8 million for 2006, compared to net cash provided by investing activities of approximately $26.3 million for 2005, and to net cash used in investing activities of approximately $45.0 million for 2004. Cash was used in 2006 mainly for the purchase of marketable securities and also for purchase of property and equipment, and for the completion of the acquisition of V-Secure Technologies Inc., partially offset by the sale and redemption of marketable securities and bank deposits. Cash was provided in 2005

mainly from redemption of long-term bank deposits which was partially offset by the purchase of marketable securities and by the acquisition of the business of V-Secure Technologies Inc. and other property and equipment. Cash was used in 2004 mainly to purchase long-term marketable securities and for capital expenditures.

Net cash provided by financing activities was $1.6, $7.3 and $6.9 million for the years ended December 31, 2006, 2005 and 2004, respectively, generated from options exercised by our employees under the Key Employee Share Option Plans and Employee Stock Purchase Plans (see "Item 6 - Directors Senior Management and Employees - Key Employee Share Incentive Plan and Employee Stock Purchase Plan"*)*.In 2006 the amount generated from options exercises was nearly fully offset by the repurchase of our shares.

As of December 31, 2006, we had cash and cash equivalents, including short-term and long-term bank deposits and marketable securities of approximately $164.1 million, as compared to approximately $164.5 million as of December 31, 2005. Our capital requirements depend on numerous factors, including market acceptance of our products and the resources we allocate to our operating expenses. Since our inception, we have experienced substantial increases in our expenditures consistent with growth in our operations and personnel, and we may increase our expenditures in the foreseeable future in order to execute our strategy. We anticipate that operating activities as well as capital expenditures will demand the use of our cash resources. We believe that cash balances will provide sufficient cash resources to finance our operations and the projected expansion of our marketing and sales activities and research and development efforts for a period of no less than the next twelve months.

Related Parties

We have entered into a number of agreements with certain companies, of which Yehuda and Zohar Zisapel are co-founders, directors and/or principal shareholders, collectively known as the RAD-Bynet Group. Of these agreements, the lease for our headquarters in Tel-Aviv is material to our operations. We believe that the terms of the transactions in which we have entered with members of the RAD-Bynet Group are not different in any material respect from terms we could obtain from unaffiliated third parties. The pricing of the transactions was arrived at based on negotiations between the parties. Members of our management reviewed the pricing of the lease agreements and confirmed that they were not different than that which could have been obtained from unaffiliated third parties. We believe, however, that due to the affiliation between us and the RAD-Bynet Group, we have greater flexibility in certain terms than might be available from unaffiliated third parties on similar issues. In the event that the transaction with members of the RAD-Bynet Group is terminated and we enter into similar transactions with unaffiliated third parties, that flexibility may not be available to us.

In addition, the Company purchases different services from third parties at special rates offered to the RAD-Bynet Group, such as car leases, maintenance, insurance and communication services. In the event that we cease to be a member of the RAD-Bynet Group, we may not be able to obtain the current rates for such services.

Impact of Inflation and Currency Fluctuations

A devaluation of the U.S. dollar against the NIS and or appreciation or depreciation of the Euro to the dollar has direct influence on the US dollar cost of our operations. Most of our sales are denominated in dollars or are dollar-linked and we incur a portion of our expenses, principally salaries and related personnel expenses, in Israel - in NIS, and in Europe - in Euros. An appreciation of the NIS, or, unless offset by a devaluation of the NIS, inflation in Israel, will