Allot Communications Ltd.
Form 20-F
April 08, 2010

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

Form 20-F

(Mark One)

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

OR

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

For the fiscal year ended December 31, 2009

OR

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

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…………………………………….

For the transition period from ______ to ______

Commission File Number 001-33129

ALLOT COMMUNICATIONS LTD.
(Exact Name of Registrant as specified in its charter)

ISRAEL
(Jurisdiction of incorporation or organization)

22 Hanagar Street
Neve Ne’eman Industrial Zone B

Hod-Hasharon 45240
Israel
(Address of principal executive offices)

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

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

Ordinary shares
NIS 0.10 par value per share

Title of Class

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

Indicate the number of outstanding shares of each of the issuer's classes of capital or common stock as of December 31, 2009: 22,397,062 ordinary shares, NIS 0.10 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

Yes o   No x

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

Yes o   No x

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

Yes x   No ¨

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

Large accelerated filer o   Accelerated filer o   Non-accelerated filer x

Indicate by check mark basis of accounting the registrant has used to prepare the financial statements included in this filing:

U.S. GAAP x	International Financial Reporting Standards as issued by the International Accounting Standards Board o	Other o

If “Other” has been checked in response to the previous question, indicate by check mark which financial statement item the registrant has elected to follow.

Item 17 ¨ Item 18 ¨

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

Yes o   No x

PRELIMINARY NOTES

Terms

As used herein, and unless the context suggest otherwise, the terms "Allot," "Company," "we," "us" or "ours" refer to Al Communications Ltd.

Forward-Looking Statements

In addition to historical facts, this annual report on Form 20-F contains forward-looking statements within the safe harbor provisions of the U.S. Private Securities Litigation Reform Act of 1995. We have based these forward-looking statements on our current expectations and projections about future events. These statements include but are not limited to:

- statements regarding the expected growth in the use of particular broadband applications;
- statements as to our ability to meet anticipated cash needs based on our current business plan;
- statements as to the impact of the rate of inflation and the political and security situation on our business;
- statements regarding auction-rate securities and their expected impact on our liquidity;
- statements regarding the price and market liquidity of our ordinary shares;
- statements as to our ability to retain our current suppliers and subcontractors;
- statements regarding our future performance, sales, gross margins, expenses (including stock-based compensation expenses) and cost of revenues; and
- statements regarding whether we will be classified as a passive foreign investment company.

These statements may be found in the sections of this annual report on Form 20-F entitled "ITEM 3: Key Information—Risk Factors," "ITEM 4: Information on Allot," "ITEM 5: Operating and Financial Review and Prospects," "ITEM 10: Additional Information—Taxation—United States Federal Income Taxation—Passive Foreign Investment Company Considerations" and elsewhere in this annual report, including the section of this annual report entitled "ITEM 4: Information on Allot—Business Overview—Overview" and "ITEM 4: Information on Allot—Business Overview—Indu Background," which contains information obtained from independent industry sources. 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 "ITEM 3: Key Information—Risk Factors" and elsewhere in this annual report.

In addition, statements that use the terms "believe," "expect," "plan," "intend," "estimate," "anticipate" and similar expression intended to identify forward-looking statements. All forward-looking statements in this annual report reflect our current views about future events and are based on assumptions and are subject to risks and uncertainties that could cause our actual results to differ materially from future results expressed or implied by the forward-looking statements. Many of these factors are beyond our ability to control or predict. You should not put undue reliance on any forward-looking statements. Unless we are required to do so under U.S. federal securities laws or other applicable laws, we do not intend to update or revise any forward-looking statements.

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PART I

ITEM 1: Identity of Directors, Senior Management and Advisers

Not applicable.

ITEM 2: Offer Statistics and Expected Timetable

Not applicable.

ITEM 3: Key Information

A. Selected Financial Data

You should read the following selected consolidated financial data in conjunction with "ITEM 5: Operating and Financial Review and Prospects" and our consolidated financial statements and the related notes included elsewhere in this annual report on Form 20-F. The consolidated statements of operations data for the years ended December 31, 2007, 2008 and 2009 and the consolidated balance sheet data as of December 31, 2008 and 2009 are derived from our audited consolidated financial statements included in "ITEM 18: Financial Statements," which have been prepared in accordance with generally accepted accounting principles in the United States. The consolidated statements of operations for the years ended December 31, 2005 and 2006 and the consolidated balance sheet data as of December 31, 2005, 2006 and 2007 have been derived from our audited consolidated financial statements which are not included in this annual report.

	Year ended December 31,				
	2005	2006	2007	2008	2009
	(in thousands of U.S. dollars, except per share and share data)				
Consolidated Statements of Operations:					
Revenues:					
Products	$18,498	$28,756	$25,073	$27,121	$29,641
Services	4,474	5,388	7,429	9,980	12,110
Total revenues	22,972	34,144	32,502	37,101	41,751
Cost of revenues(1):					
Products	4,481	6,435	6,603	8,198	10,094
Services	938	1,162	1,416	1,498	1,741
Total cost of revenues	5,419	7,597	8,019	9,696	11,835
Gross profit	17,553	26,547	24,483	27,405	29,916
Operating expenses:					
Research and development, gross	6,652	9,340	11,755	14,635	11,705
Less royalty-bearing participation	727	1,811	2,371	2,671	2,440
Research and development, net(1)	5,925	7,529	9,384	11,964	9,265
Sales and marketing(1)	11,887	15,457	18,081	19,781	20,408
General and administrative(1)	2,380	3,464	5,583	6,174	5,541
In process research and development	-	-	-	244	-
Total operating expenses	20,192	26,450	33,048	38,163	35,214
Operating income (loss)	(2,639)	97	(8,565)	(10,758)	(5,298)
Financing and other income (expenses), net	45	630	(845)	(5,517)	(2,311)

Income (loss) before income tax expenses (benefit)	(2,594)	727	(9,410)	(16,275)	(7,609)
Income tax expenses (benefit)	(218)	111	530	220	63
Net income (loss)	$(2,376)	$616	$(9,940)	$(16,495)	$(7,672)
Basic and diluted net earnings (loss) per share	$(0.81)	$0.04	$(0.46)	$(0.75)	$(0.35)
Weighted average number of shares used in computing basic net earnings (loss) per share	2,943,500	14,402,338	21,525,822	22,054,211	22,185,702
Weighted average number of shares used in computing diluted net earnings (loss) per share	2,943,500	16,423,227	21,525,822	22,054,211	22,185,702

(1) Includes stock-based compensation expense related to options granted to employees and others as follows:

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	Year ended December 31,				
	2005	2006	2007	2008	2009
	(in thousands of U.S. dollars)				
Cost of revenues	$—	$15	$48	$50	$104
Research and development expenses, net	12	157	230	321	357
Sales and marketing expenses	251	650	340	465	775
General and administrative expenses	42	539	743	866	1,062
Total	$305	$1,361	$1,361	$1,702	$2,298

	At December 31,				
	2005	2006	2007	2008	2009
	(in thousands of U.S. dollars)				
Consolidated balance sheet data:					
Cash and cash equivalents	$3,677	$7,117	$28,101	$40,029	$36,470
Marketable securities	4,581	76,114	42,614	15,319	14,490
Working capital	4,274	75,182	37,225	40,688	38,179
Total assets	17,591	99,506	94,655	82,851	82,943
Total liabilities	11,465	15,319	17,470	19,672	22,531
Accumulated deficit	(37,884)	(37,268)	(47,208)	(63,703)	(63,694)
Total shareholders' equity	6,126	84,187	77,185	63,179	60,412

B. Capitalization and Indebtedness

Not applicable.

C. Reasons for Offer and Use of Proceeds

Not applicable.

D. Risk Factors

Investing in our ordinary shares involves a high degree of risk. You should consider carefully the risks described below, together with the financial and other information contained in this annual report, before deciding to invest in our ordinary shares. If any of the following risks actually occurs, our business, financial condition and results of operations would suffer. In this case, the trading price of our ordinary shares would likely decline and you might lose all or part of your investment. The risks described below are not the only ones we face. Additional risks that we currently do not know about or that we currently believe to be immaterial may also impair our business operations.

Risks Relating to Our Business

We have a history of losses, may incur future losses and may not achieve profitability.

We have incurred net losses in each fiscal year since we commenced operations in 1997 through 2009, other than 2006. We had a net loss of $7.7 million in 2009 of which $3.0 million resulted from a net impairment charge related to auction-rate securities, or ARS, compared to a net loss of $16.5 million in 2008 of which $7.7 million resulted from an impairment charge related to ARS and a net loss of $9.9 million in 2007 of which $4.9 million resulted from an impairment charge related to ARS. We can provide no assurance that we will be able to achieve profitability and we may incur losses in the next several years as we continue to expand our sales and marketing activities and to invest in research and development. We may also incur additional impairment charges related to ARS. We may incur losses in the future and may not generate sufficient revenues in the future to achieve profitability.

We may be unable to compete effectively with other companies in our market who offer, or may in the future offer, competing technologies.

We compete in a rapidly evolving and highly competitive sector of the networking technology market. Our principal competitors are Cisco Systems, Inc. (through the acquisitions of P-Cube and Starent Networks, Corp.) and Sandvine Inc. in the service provider market, including the segment of the largest service providers, referred to as Tier 1 operators, and Blue Coat Systems, Inc. (through its acquisition of Packeteer Inc.) in the enterprise market. Our competitors have also identified the potential market opportunity of Tier 1 operators and we therefore expect intensive competition in this segment in the future. We also compete with a number of smaller competitors, such as CloudShield Technologies, Inc. and Procera Networks, Inc., and we compete indirectly with router and switch infrastructure companies with features that address some of the problems that our products address. We also face competition from companies that offer partial or alternative solutions addressing only one aspect of the challenges facing broadband providers, such as network monitoring or security. Our competitors may announce new products, services or enhancements that better meet the needs of customers or changing industry requirements, or may offer alternative methods to achieve customer objectives. One of our direct competitors, Cisco Systems, is substantially larger than we are and has significantly greater financial, sales and marketing, technical, manufacturing and other resources. The entry of new competitors into our market and acquisitions of our existing competitors by companies with significant resources and established relationships with our potential customers could result in increased competition and harm our business. Increased competition may cause price reductions, reduced gross margins and loss of market share, any of which could have a material adverse effect on our business, financial condition or result of operations.

If current unfavorable global economic conditions persist or worsen, our business, operating results and financial condition could be adversely effected.

The crisis in the financial and credit markets in the United States, Europe and Asia that began in 2008 has led to a global economic slowdown, with economies in those territories showing significant weakness. If the economies of any part of the world continue to be weak or further deteriorate, many enterprises, telecommunications carriers and service providers may reduce or postpone their capital investments significantly. This could result in reductions in sales of our products or services and longer sales cycles, slower adoption of new technologies and increased price competition. We continuously monitor market trends and intend to take such steps as we deem appropriate to adjust our operations, including measures to lower our expenditures. Since a substantial portion of our operating expenses consist of salaries, we may not be able to reduce our operating expenses in line with any reduction in revenues or may elect not to do so for business reasons. We will need to continue to generate increased revenues and manage our costs to achieve profitability. If global economic and market conditions do not improve, or continue to deteriorate, it may lead to increase in our inventories, decrease our revenues, result in additional pressure on the price of our products, prolong payment terms, and increase the risk that we incur bad debts, each of which would have a material adverse effect on our results of operations and cash flow from operations.

The market for our products is still in its early stage and our growth may be harmed if Tier 1 operators and midsize service providers, do not adopt our solutions.

Our portfolio of hardware platforms and software applications uses our technology to transform broadband pipes into smart networks that can rapidly and efficiently deploy value added Internet services. We believe that the market for our technology is still in its early stage. We believe that the Tier 1 operators and midsize service providers, present a significant market opportunity and are an important element of our long term strategy. Nevertheless, they may decide that full visibility into their networks or highly granular control over content based applications is not critical to their business. They may also determine not to adopt the value added services we offer or that certain applications, such as VoIP or Internet video, can be adequately prioritized in their networks using router and switch infrastructure products without the use of our technology. They may also, in some instances, face regulatory constraints that could change the characteristics of the markets. They may also seek an embedded deep packet inspection, or DPI, solution in capital equipment devices such as routers rather than the stand-alone solution offered by us. Furthermore, widespread adoption of our products by Tier 1 operators and midsize service providers may require that they migrate to a new business model based on offering subscriber and application-based tiered services and market these new services successfully to consumers. If they decide not to adopt our technology, our market opportunity would be reduced and our growth rate may be harmed.

Demand for our products depends in part on the rate of adoption of bandwidth-intensive broadband applications, such as Internet video and online video gaming applications and applications highly sensitive to network delays such as voice over Internet protocol (VoIP).

Our products are used by service providers and enterprises to monitor and manage bandwidth-intensive applications that cause congestion in broadband networks and impact the quality of experience of users. Demand for our products is driven particularly by the growth in applications, which are highly sensitive to network delays and therefore require efficient network management. These applications include VoIP, Internet video and television and online video gaming applications. If the rapid growth in adoption of VoIP and in the popularity of Internet video and online video gaming applications does not continue, the demand for our products may not grow as anticipated.

Our revenues and business will be harmed if we do not keep pace with changes in broadband applications and with advances in technology.

We will need to invest heavily in developing our technology in order to keep pace with rapid changes in applications, increased broadband network speeds and with our competitors' efforts to advance their technology. Designers of broadband applications that our products identify and manage are using increasingly sophisticated methods to avoid detection and management by network operators. Even if our products successfully identify a particular application, it is sometimes necessary to distinguish between different types of traffic belonging to a single application. Accordingly, we face significant challenges in ensuring that we identify new applications as they are introduced without impacting network performance, especially as networks become faster. This challenge is increased as we seek to expand sales of our products in new geographic territories because the applications vary from country to country and region to region. If we fail to address the needs of customers in particular geographic markets and if we fail to develop enhancements to our products in order to keep pace with advances in technology, our business and revenues will be adversely affected.

The network equipment market is subject to rapid technological progress and to compete we need to achieve widespread market acceptance.

The network equipment market is characterized by rapid technological progress, frequent new product introductions, changes in customer requirements and evolving industry standards. Developments in routers and routing software could also significantly reduce demand for and sales of our products, and cause our products to become obsolete, which may result in inventory write downs. Alternative technologies could achieve widespread market acceptance and displace the technology on which we have based our product architecture. We can give no assurance that our technological approach will achieve broad market acceptance or that other technology or devices will not supplant our products and technology.

Demand for our products may be impacted by government regulation of the telecommunications industry.

Carriers are subject to government regulation in a number of jurisdictions in which we sell our products. There are several proposals in the United States and Europe for regulating service providers' ability to prioritize applications in their networks. Advocates for regulating this industry claim that collecting premium fees from certain "preferred" applications would distort the market for Internet applications in favor of larger and better-funded content providers and would impact end users who purchased broadband access only to experience differing response times in interacting with various content providers. Opponents believe that content providers who support bandwidth-intensive applications should be required to pay service providers a premium in order to support further network investments. The U.S. Federal Communications Commission held hearings to discuss "net neutrality," which has been defined as service providers treating Internet content equally and not interfering with download speeds, regardless of the size or source of content. To date, the Federal Communications Commission has issued limited guidance on this issue and is currently reviewing it on a case-by-case basis. In August 2008, the Federal Communications Commission issued a ruling prohibiting Comcast, the second-largest broadband provider in the United States, from delaying some peer-to-peer traffic on its network. Comcast filed a court appeal in September 2008 seeking a review of such ruling. In April 2010, a federal appeals court ruled that the Federal Communications Commission had limited power over Web traffic under current law. This ruling could prompt efforts in Congress to amend the law in order to give the Federal Communications Commission explicit authority to regulate Internet service. Demand from carriers for the traffic management and subscriber management features of our products could be adversely affected if regulations prohibit, or limit, service providers from managing traffic on their networks. A decrease in demand for these features could adversely impact sales of our products.

We need to increase the functionality of our products and offer additional features and value added services in order to maintain or increase our profitability.

The market in which we operate is highly competitive and unless we continue to enhance the functionality of our products and add additional features, our competitiveness may be harmed and the average selling prices for our products will decrease over time. Such a decrease generally results from the introduction by competitors of competing products and from the standardization of DPI technology. To counter this trend, we endeavor to enhance our products by offering higher system speeds, and additional features and value added services, such as additional security functions, supporting additional applications and enhanced reporting tools. We may also need to reduce our per unit manufacturing costs at a rate equal to or faster than the rate at which selling prices decline. If we are unable to reduce these costs or to offer increased functionally and features, our profitability may be adversely affected.

Under the current laws of some jurisdictions in which we operate, we may not be able to enforce employees' covenants not to compete and therefore may be unable to prevent our competitors from benefiting from the expertise of some of our former employees.

It is our practice to have our employees sign appropriate non-compete agreements where permitted under applicable law. These agreements prohibit our employees, if they cease working for us, from competing directly with us or working for our competitors for a limited period. Under the current laws of some jurisdictions in which we operate, we may be unable to enforce these agreements and it may be difficult for us to restrict our competitors from gaining the expertise our former employees gained while working for us.

We may become dependent on one or more significant customers, and the loss of any such significant customer could harm our results of operations.

The loss of any significant customer or a significant decrease in business from any such customer could harm our results of operations and financial condition. In addition, revenues from individual customers may fluctuate from time to time based on the timing and the terms under which further orders are received and the duration of the delivery and implementation of such orders. During 2007 and 2008, no single customer accounted for more than 10% of our revenues. In 2009, we had a significant customer, which accounted for 15% of our revenues.

We depend on third parties to market, sell, install, and provide initial technical support for our products.

We depend on third party channel partners, such as distributors, resellers, OEMs and system integrators, to market and sell our products to end-customers. Our channel partners are also responsible for installing our products and providing initial customer support for them. As a result, we depend on the ability of our channel partners to market and sell our products successfully to end-customers. We also depend on our ability to maintain our relationships with existing channel partners and develop relationships in key markets with new channel partners. We cannot assure you that our channel partners will market our products effectively, receive and fulfill customer orders of our products on a timely basis or continue to devote the resources necessary to provide us with effective sales, marketing and technical support. In addition, any failure by our channel partners to provide adequate initial support to end-customers could result in customer dissatisfaction with us or our products, which could result in a loss of customers, harm our reputation and delay or limit market acceptance of our products. Our products are complex and it takes time for a new channel partner to gain experience in their operation and installation. Therefore, it may take a period of time before a new channel partner can successfully market, sell and support our products if an existing channel partner ceases to sell our products.

Our agreements with channel partners are generally not exclusive and our channel partners may market and sell products that compete with our products. Our agreements with our distributors and resellers are usually for an initial one-year term and following the expiration of this term, they can be terminated by either party. We can give no assurance that these agreements will not be terminated upon proper notice and any such termination may adversely affect our profitability and results of operations.

Sales of our products to large service providers can involve a lengthy sales cycle, which may impact the timing of our revenues and result in us expending significant resources without making any sales.

The length of our sales cycles to large service providers, including carriers, mobile operators and cable operators, is generally lengthy because these end-customers consider our products to be capital equipment and undertake significant testing to assess the performance of our products within their networks. As a result, we may invest significant time from initial contact with a large service provider until that end-customer decides to incorporate our products in its network. We may also expend significant resources attempting to persuade large service providers to incorporate our products into their networks without success. Even after deciding to purchase our products, initial network deployment of our products by a large service provider may last up to three years. If a competitor succeeds in convincing a large service provider to adopt that competitor's product, it may be difficult for us to displace the competitor because of the cost, time, effort and perceived risk to network stability involved in changing solutions. As a result, we may incur significant expense without generating any sales.

We are dependent on our traffic management systems and network management application suites for the substantial majority of our revenues.

We currently derive the substantial majority of our revenues from sales of our NetEnforcer traffic management system, NetXplorer and Subscriber Management Platform (SMP) network management application suites, the Service Gateway platforms, and from maintenance and support contracts related to these products. In the past two years, we increased sales of our Service Gateway platforms, which combines a powerful DPI engine and array of services into a fully integrated, carrier-class platform. In addition, in 2009 we experienced increased demand for our SMP network management application suite. However, sales of our NetEnforcer traffic management system and NetXplorer network management system continued to account for a significant portion of our revenues in 2009 and we currently expect these systems will continue to account for a significant portion of our revenues for the immediate future. As a result, any factor adversely affecting our ability to sell, or the pricing of or demand for, our NetEnforcer traffic management system and NetXplorer network management system would severely harm our ability to generate revenues.

We integrate various third-party solutions into, or together with, our products and may integrate or offer additional third-party solutions in the future. If we lose the right to use such solutions, our sales could be disrupted and we would have to spend additional capital to replace such components.

We integrate various third-party solutions into, or together with, our products and may integrate or offer additional third-party solutions in the future. Sales of our products could be disrupted if such third party solutions were either no longer available to us or no longer offered to us on commercially reasonable terms. In either case, we would be required to spend additional capital to either redesign our products to function with alternate third party solutions or develop substitute components ourselves. We might as a result be forced to limit the features available in our current or future product offerings.

Our products are highly technical, and any undetected software or hardware errors in our products could have a material adverse effect on our operating results.

Our products are complex and are incorporated into broadband networks which are a major source of revenue for service providers and which support critical applications for subscribers and enterprises. Due to the complexity of our products and variations among customers' network environments, we may not detect product defects until full deployment in our customers' networks. Regardless of whether warranty coverage exists for a product, we may be required to dedicate significant technical resources to resolve any defects. If we encounter significant product problems, we could experience, among other things, loss of major customers, cancellation of product orders, increased costs, delay in recognizing revenue, and damage to our reputation. In addition, we could face claims for product liability, tort, or breach of warranty. Defending a lawsuit, regardless of its merit, is costly and may divert management's attention. In addition, if our business liability insurance is inadequate or future coverage is unavailable on acceptable terms or at all, our financial condition could be harmed.

The complexity and scope of the solutions and services we provide to larger service providers is increasing. Larger projects entail greater operational risk and an increased chance of failure.

The complexity and scope of the solutions and services we provide to larger service providers is increasing. The larger and more complex such projects are, the greater the operational risks associated with such projects. These risks include failure to fully integrate our products into the service provider's network, with third party products and complex environments, and our dependence on subcontractors and partners for the successful and timely completion of such projects. Failure to complete a larger project successfully could expose us to potential contractual penalties, claims for breach of contract and in extreme cases, to cancellation of the entire project, or increase the likelihood we have difficulty in collecting payment and recognizing revenues.

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We currently depend on a single subcontractor to manufacture and provide hardware warranty support for our legacy NetEnforcer traffic management systems and another subcontractor to provide similar services for our Service Gateway platforms and newer NetEnforcer traffic management systems. If either subcontractor experiences delays, disruptions, quality control problems or a loss in capacity, it could materially adversely affect our operating results.

We currently depend on a single subcontractor, R.H. Electronics Ltd., to manufacture, assemble, test, package and provide hardware warranty support for our legacy NetEnforcer AC-400, AC-800, AC-1000 and AC-2500 traffic management systems, and another subcontractor, Flextronics (Israel) Ltd., a subsidiary of Flextronics, a global electronics manufacturing, services company, to provide similar services for our Service Gateway platforms and our newer NetEnforcer AC-1400, AC-3000, AC-5000 and AC-10000 traffic management systems. In addition, our agreements with Flextronics (Israel) and R.H. Electronics require them to procure and store key components for our products at their facilities. If either of them experiences delays, disruptions or quality control problems in manufacturing our products, or if we fail to effectively manage the relationship with them, shipments of products to our customers may be delayed and our ability to deliver products to customers could be materially adversely affected. Our agreements with Flextronics (Israel) and R.H. Electronics are automatically renewed annually for additional one-year terms. R.H. Electronics may elect not to renew our agreement with them by giving us at least 90 days prior notice to the expiration of any such term. Furthermore, R.H. Electronics may terminate our agreement with them at any time during the term upon 120 days prior notice. Flextronics (Israel) may terminate our agreement at any time during the term upon 180 days prior notice. We expect that it would take approximately six months to transition manufacturing of our products to an alternate manufacturer and our inventory of completed products may not be sufficient for us to continue delivering products to our customers on a timely basis during any such transition. Therefore, the loss of either R.H. Electronics or Flextronics (Israel) would adversely affect our sales and operating results, and harm our reputation.

The facilities of both R.H. Electronics and Flextronics (Israel) are located in northern Israel and are in range of rockets that were fired during 2006 from Lebanon into Israel. In the event that the facilities of either contractor are damaged as a result of hostile action, our ability to deliver products to customers could be materially adversely affected. See also "—Conditions in Israel could adversely affect our business, and —Our operations may be disrupted by the obligations of personnel to perform military service."

Certain hardware components for our products come from single or limited sources, and we could lose sales if these sources fail to satisfy our supply requirements.

Certain hardware components used in our products are obtained from single or limited sources. Since our systems have been designed to incorporate these specific components, any change in these components due to an interruption in supply or our inability to obtain such components on a timely basis would require engineering changes to our products before we could incorporate substitute components. Such changes could be costly and result in lost sales. In particular, the central processing unit for our NetEnforcer AC-400 and our NetEnforcer AC-800 is from Intel Corporation, the network processor for our NetEnforcer AC-1000 and our NetEnforcer AC-2500 is from Hifn Inc., and the central processing unit for our Service Gateway platforms and our NetEnforcer AC-1400, AC-3000, AC-5000 and AC-10000 is from NetLogic Microsystems, Inc. (through the acquisition of Raza Microelectronics, Inc.). We do not have a supply agreement with Intel Corporation and the agreements with our other suppliers do not contain any minimum purchase or supply commitments.

If we or our contract manufacturer fail to obtain components in sufficient quantities when required, our business could be harmed. Our suppliers also sell products to our competitors. Our suppliers may enter into exclusive arrangements with our competitors, stop selling their products or components to us at commercially reasonable prices or refuse to sell their products or components to us at any price. Our inability to obtain sufficient quantities of single-source or limited-sourced components, or to develop alternative sources for components or products would harm our ability to maintain and expand our business.

If we fail to attract and retain skilled employees, we may not be able to timely develop, sell or support our products.

Our success depends in large part on the continued contribution of our research and development, sales and marketing and managerial personnel. If our business continues to grow, we will need to hire additional qualified research and development, sales and marketing and managerial personnel to succeed. The process of hiring, training and successfully integrating qualified personnel into our operation is a lengthy and expensive one. The market for qualified personnel is very competitive because of the limited number of people available with the necessary technical skills, sales skills and understanding of our products and technology. This is particularly true in Israel, where competition for qualified personnel is intense. Our failure to hire and retain qualified personnel could cause our revenues to decline and impair our ability to meet our research and development and sales objectives.

We may expand our business or enhance our technology through acquisitions that could result in diversion of resources and extra expenses. This could disrupt our business and adversely affect our financial condition.

Part of our strategy is to selectively pursue partnerships and acquisitions that provide us access to complementary technologies and accelerate our penetration into new markets. In 2008, we acquired the business of Esphion, a developer of network protection solutions for carriers and internet service providers, which increased the scope of our product offering. The negotiation of acquisitions, investments or joint ventures, as well as the integration of acquired or jointly developed businesses or technologies, could divert our management’s time and resources. Acquired businesses, technologies or joint ventures may not be successfully integrated with our products and operations. We may not realize the intended benefits of any acquisition, investment or joint venture and we may incur future losses from any acquisition, investment or joint venture.

In addition, acquisitions could result in:

Ÿ substantial cash expenditures;

Ÿ potentially dilutive issuances of equity securities;

Ÿ the incurrence of debt and contingent liabilities;

Ÿ a decrease in our profit margins; and

Ÿ amortization of intangibles and potential impairment of goodwill.

If acquisitions disrupt our operations, our business may suffer.

Carriers, especially in North America, may condition a purchase of our products upon our receipt of a certification that such products meet the Network Equipment Building System (NEBS) requirements.

Carriers, especially in North America, often require that products they purchase meet Network Equipment Building System (NEBS) certification requirements, which relate the reliability of telecommunications equipment. Our Service Gateway platforms are designed to meet NEBS certification requirements, but carriers may not choose to use our systems until we receive the certification.

If we are unable to successfully protect the intellectual property embodied in our technology, our business could be harmed significantly.

Know-how relating to networking protocols, building carrier-grade systems and identifying applications is an important aspect of our intellectual property. To protect our know-how, we customarily require our employees, distributors, resellers, software testers and contractors to execute confidentiality agreements or agree to confidentiality undertakings when their relationship with us begins. Typically, our employment contracts also include the following clauses: assignment of intellectual property rights for all inventions developed by employees, non-disclosure of all confidential information, and non-compete clauses, which generally restrict the employee for six months following termination of employment. The enforceability of non-compete clauses in certain jurisdictions in which we operate may be limited. We cannot provide any assurance that the terms of these agreements are being observed and will be observed in the future. Because our product designs and software are stored electronically and thus are highly portable, we attempt to reduce the portability of our designs and software by physically protecting our servers through the use of closed networks, which prevent external access to our servers. We cannot be certain, however, that such protection will adequately deter individuals or groups from wrongful access to our technology. Monitoring unauthorized use of intellectual property is difficult, and some foreign laws do not protect proprietary rights to the same extent as the law of the United States. We cannot be certain that the steps we have taken to protect our proprietary information will be sufficient. In addition, to protect our intellectual property, we may become involved in litigation, which could result in substantial expenses, divert the attention of management, cause significant delays, materially disrupt the conduct of our business or adversely affect our revenue, financial condition and results of operations.

As of December 31, 2009, we had a limited patent portfolio. We had two issued U.S. patents and two pending U.S. patent applications. While we plan to protect our intellectual property with, among other things, patent protection, there can be no assurance that:

Ÿ current or future U.S. or foreign patents applications will be approved;

- Ÿ our issued patents will protect our intellectual property and not be held invalid or unenforceable if challenged by third parties;

- Ÿ we will succeed in protecting our technology adequately in all key jurisdictions in which we or our competitors operate;

- Ÿ the patents of others will not have an adverse effect on our ability to do business; or

- Ÿ others will not independently develop similar or competing products or methods or design around any patents that may be issued to us.

The failure to obtain patents, inability to obtain patents with claims of a scope necessary to cover our technology, or the invalidation of our patents, may weaken our competitive position and may adversely affect our revenues.

We may be subject to claims of intellectual property infringement by third parties that, regardless of merit, could result in litigation and our business, operating results or financial condition could be materially adversely affected.

There can be no assurance that we will not receive communications from third parties asserting that our products and other intellectual property infringe, or may infringe their proprietary rights. We are not currently subject to any proceedings for infringement of patents or other intellectual property rights and are not aware of any parties that intend to pursue such claims against us. Any such claims, regardless of merit, could result in litigation, which could result in substantial expenses, divert the attention of management, cause significant delays and materially disrupt the conduct of our business. As a consequence of such claims, we could be required to pay a substantial damage award, develop non-infringing technology, enter into royalty-bearing licensing agreements, stop selling our products or re-brand our products. If it appears necessary, we may seek to license intellectual property that we are alleged to infringe. Such licensing agreements may not be available on terms acceptable to us or at all. Litigation is inherently uncertain and any adverse decision could result in a loss of our proprietary rights, subject us to significant liabilities, require us to seek licenses from others and otherwise negatively affect our business. In the event of a successful claim of infringement against us and our failure or inability to develop non-infringing technology or license the infringed or similar technology, our business, operating results or financial condition could be materially adversely affected.

We use certain “open source” software tools that may be subject to intellectual property infringement claims, the assertion of which could impair our product development plans, interfere with our ability to support our clients or require us to pay licensing fees.

Certain of our products contain open source code and we may use more open source code in the future. Open source code is code that is covered by a license agreement that permits the user to liberally copy, modify and distribute the software without cost, provided that users and modifiers abide by certain licensing requirements. The original developers of the open source code provide no warranties on such code.

As a result of our use of open source software, we could be subject to suits by parties claiming ownership of what we believe to be open source code and we may incur expenses in defending claims that we did not abide by the open source code license. If we are not successful in defending against such claims, we may be subject to monetary damages or be required to remove the open source code from our products. Such events could disrupt our operations and the sales of our products, which would negatively impact our revenues and cash flow. In addition, under certain conditions, the use of open source code to create derivative code may obligate us to make the resulting derivative code available to others at no cost. If we are required to publicly disclose the source code for such derivative products or to license our derivative products that use an open source license, our previously proprietary software products would be available to others, including our customers and competitors without charge.

We monitor our use of such open source code to avoid subjecting our products to conditions we do not intend. The use of such open source code, however, may ultimately subject some of our products to unintended conditions so that we are required to take remedial action that may divert resources away from our development efforts.

We have invested a substantial portion of our cash in auction-rate securities, or ARS, which subjects us to liquidity and investment risk. Due to uncertainties in the capital markets regarding auction-rate securities, we recorded impairment charges in 2007, 2008 and 2009, and, if the fair value of these investments were to decline further, we could be required to record further impairment charges related to these investments.

As of December 31, 2009, we had $27.9 million of principal invested in ARS, which consist of interests in collateralized debt obligations supported by pools of residential and commercial mortgages or credit cards, insurance securitizations and other structured credits, including corporate bonds. We determined the fair value of the ARS based on a third party valuation using a discounted cash flow model, the inputs and assumptions for which include the market conditions related to such security as well as the underlying structure of the security, the financial standing of the issuer, stated maturities, estimates of the probability of the issue being called at par prior to final maturity, estimates of the probability of defaults and recoveries, auctions failure and successful auction or repurchase at par for each period, expected changes in interest rates paid on the securities, interest rates paid on similar instruments. Unobservable inputs and assumptions used in these models are significant to the fair value of the investments. In 2009, we recorded an impairment charge of $3.0 million resulting from further devaluation of our ARS portfolio. In addition, during 2009 we recorded an unrealized gain of $2.2 million to other comprehensive income in our balance sheet for appreciation of certain ARS in our portfolio. As of December 31, 2009, the fair value of the ARS on our balance sheet was $14.5 million. See "—Critical Accounting Policies and Estimates— Marketable Securities" below.

We cannot predict if or when the liquidity of these ARS will improve. We continue to monitor the market for ARS although there is currently a very limited secondary market for such securities. If these investments continue to experience further devaluation, we will record further impairment charges that could adversely affect our consolidated financial condition and results of operations. In addition, if the fair value of certain investments that have not experienced any devaluation were to decline, management would be required to evaluate whether such decline related to credit losses. The amount of any impairment loss which is determined to be credit loss would be immediately recorded in the consolidated statement of operations. Such an impairment charge could materially and adversely affect our consolidated financial condition and results of operations. See Notes 2(g) and 4 to our consolidated financial statements for further information, including changes in the accounting treatment of ARS.

Our international operations expose us to the risk of fluctuation in currency exchange rates.

Our revenues are generated primarily in U.S. dollars and partially in euros and other currencies. A major portion of our expenses are denominated in U.S. dollars. As a result, we consider the U.S. dollar to be our functional currency. Other significant portion of our expenses are denominated in shekels and to a lesser extent in euros and other Asian currencies. Our shekel-denominated expenses consist principally of salaries and related personnel expenses. We anticipate that a material portion of our expenses will continue to be denominated in shekels. If the U.S. dollar weakens against the shekel or other currencies we are exposed to, there will be a negative impact on our results of operations. In addition, since a portion of our revenue is not incurred in dollars, therefore, fluctuations in exchange rates between the dollar and the currencies in which such revenue is incurred may have a material effect on our results of operations and financial condition and if we wish to maintain the dollar-denominated value of our products in non-U.S. markets, devaluation in the local currencies of our customers relative to the U.S. dollar could cause our customers to cancel or decrease orders or default on payment. See "ITEM 11: Quantitative and Qualitative Disclosures about Market Risk."

We may receive much lower interest income on our interest bearing investments due to changes in interest rates.

We have significant amount of cash that is currently invested primarily in interest bearing investments such as bank time deposits, money market funds, U.S. government treasury bills and ARS. These investments expose us to the changes in interest rates. If interest rates further decline, our results of operations may be adversely affected due to lower interest income from these investments.

Risks Related to Our Ordinary Shares

The share price of our ordinary shares has been and may continue to be volatile.

Our quarterly financial performance is likely to vary in the future, and may not meet our expectations or the expectations of analysts or investors, which may lead to additional volatility in our share price. The market price of our ordinary shares may be volatile and could fluctuate substantially due to many factors, including, but not limited, to:

Ÿ announcements or introductions of technological innovations or new products, or product enhancements or pricing policies by us or our competitors;

Ÿ disputes or other developments with respect to our or our competitors' intellectual property rights;

Ÿ announcements of strategic partnerships, joint ventures or other agreements by us or our competitors;

Ÿ recruitment or departure of key personnel;

Ÿ regulatory developments in the markets in which we sell our products;

Ÿ our sale of ordinary shares or other securities in the future;

Ÿ changes in the estimation of the future size and growth of our markets;

Ÿ market conditions in our industry, the industries of our customers and the economy as a whole; or

Ÿ implementation of a share buyback plan.

Share price fluctuations may be exaggerated if the trading volume of our ordinary shares is too low. The lack of a trading market may result in the loss of research coverage by securities analysts. Moreover, we cannot assure you that any securities analysts will initiate or maintain research coverage of our company and our ordinary shares. If our future quarterly operating results are below the expectations of securities analysts or investors, the price of our ordinary shares would likely decline. Securities class action litigation has often been brought against companies following periods of volatility. In April 2007, we announced that our revenue and earnings estimates for the first quarter of 2007 and that the 2007 fiscal year would be lower than previously projected. The closing price of our ordinary shares on the date following the announcement was $2.04, or 22%, lower than the closing price on the previous day. Subsequently, in May and June 2007, we and certain of our officers and directors were named as defendants in a number of purported securities class action lawsuits filed in the United States District Court for the Southern District of New York. See "ITEM 8: Financial Information—Consolidated Statements and Other Financial Information—Legal Proceedings."

If we cannot meet NASDAQ's continued listing requirements, NASDAQ may delist our ordinary shares, which would have an adverse impact on the liquidity and market price of our ordinary shares.

Our ordinary shares are currently listed on the NASDAQ Stock Market. Under NASDAQ rules, shares can be delisted and not allowed to trade on NASDAQ if the closing bid price of the stock over a 30 consecutive trading-day period is less than $1.00. If the price of our ordinary shares decline below the minimum listing requirement, it may be delisted from the NASDAQ Stock Market. A delisting of our ordinary shares could negatively impact us by reducing their liquidity and market price and the number of investors willing to hold or acquire our ordinary shares. This could negatively impact our ability to raise equity financing.

Our shareholders do not have the same protections afforded to shareholders of a U.S. listed company because we have elected to use an exemption available to foreign private issuers from certain NASDAQ corporate governance requirements.

As a foreign private issuer, we are permitted under NASDAQ Marketplace Rule 5615(a)(3) to follow Israeli corporate governance practices instead of the NASDAQ Stock Market requirements that apply to U.S. listed companies. As a condition to following Israeli corporate governance practices, we must disclose which requirements we are not following and the equivalent Israeli requirement. We must also provide NASDAQ with a letter from our outside counsel in our home country, Israel, certifying that our corporate governance practices are not prohibited by Israeli law. We rely on this "foreign private issuer exemption" with respect to the following two items: First, we follow the requirements of Israeli law with respect to the quorum requirement for meetings of our shareholders, which are different from the requirements of Rule 5620(c). As a result, the quorum required for an ordinary meeting of shareholders consists of at least two shareholders present in person, by proxy or by written ballot, who hold or represent between them at least 25% of the voting power of our shares. Second, we follow Israeli law requirements with respect to the requirement to seek shareholder approval for equity compensation plans, which are significantly different the requirements of Rule 5635(c). Under Israeli law, we may amend our 2006 Incentive Compensation Plan by approval of our board of directors and without shareholder approval as is generally required under Rule 5635(c). As a result of these exemptions, our shareholders do not have the same protections as are afforded to shareholders of a U.S. listed company. We may in the future provide NASDAQ with an additional letter or letters notifying NASDAQ that we are following our home country practices, consistent with Israeli law and practices, in lieu of other requirements of Rule 5600.

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Defending securities class action litigation requires extensive management attention and resources, and an unfavorable outcome could materially adversely affect our business, results of operations and financial condition.

Defending the purported securities class action lawsuits to which we are subject could be expensive, lengthy and disruptive to normal business operations, and could require extensive management attention and resources, regardless of the merit of these lawsuits. Moreover, we cannot predict the results of legal proceedings, and an unfavorable resolution of these lawsuits as a result of a settlement, or a court decision, could materially adversely affect our business, results of operations and financial condition.

A small number of significant beneficial owners of our shares acting together will have a significant influence over matters requiring shareholder approval, which could delay or prevent a change of control.

Our executive officers and directors and their affiliates beneficially own approximately 21.5% of our outstanding ordinary shares. As a result, these shareholders, acting together, could exercise significant influence over our operations and business strategy and will have sufficient voting power to influence the outcome of matters requiring shareholder approval.

These matters may include:

Ÿ the composition of our board of directors which has the authority to direct our business and to appoint and remove our officers;

Ÿ approving or rejecting a merger, consolidation or other business combination;

Ÿ raising future capital; and

Ÿ amending our articles of association which govern the rights attached to our ordinary shares.

This concentration of ownership of our ordinary shares could delay or prevent proxy contests, mergers, tender offers, open-market purchase programs or other purchases of our ordinary shares that might otherwise give you the opportunity to realize a premium over the then-prevailing market price of our ordinary shares. This concentration of ownership may also adversely affect our share price.

Future sales of our ordinary shares in the public market and low trading volume could adversely affect our share price.

As of December 31, 2009, we had 22,397,062 ordinary shares outstanding. Approximately 23.0% of these shares are "restricted securities" available for resale on the NASDAQ Stock Market subject, however, to volume limitations under Rule 144. Most of these restricted securities are held by the largest beneficial owners of our shares. Future sales of these restricted shares, or the perception that these sales could occur, could adversely affect the market price of our ordinary shares. We have experienced a low trading volume of our ordinary shares since our initial public offering and if one or a small number of parties buys or sells a large number of our ordinary shares, we may experience volatility in our share price and the price and liquidity of our shares may be adversely affected.

Our U.S. shareholders may suffer adverse tax consequences if we are characterized as a passive foreign investment company

Generally, if for any taxable year 75% or more of our gross income is passive income, or the average percentage of our assets which produce passive income or which are held for the production of passive income ("passive assets") is at least 50%, we would be characterized as a passive foreign investment company ("PFIC") for U.S. federal income tax purposes for such taxable year. Publicly traded corporations must determine the percentage of assets on the basis of the value of their assets. No definitive guidance has been issued by the U.S. government concerning how to value the assets of a foreign public company for PFIC testing purposes. It can be inferred from the legislative history that the fair market value of the total assets of a publicly traded foreign corporation can be more easily measured, and is therefore likely to be less burdensome to taxpayers, by applying the "market capitalization" method. Under the market capitalization method, the total asset value of a company would be considered to equal the aggregate fair market value of its outstanding stock (i.e., its market capitalization) plus its outstanding liabilities, as of a relevant testing date. However, the legislative history did not specify the circumstances under which it would be appropriate to use the "market capitalization" method, or that such method was an exclusive means for valuing the total assets of a publicly traded corporation. Accordingly, if the market capitalization approach is found to be insufficient in the context of the facts and circumstances of a particular case, other reasonable valuation methods may be employed to determine the fair market value of a corporation's assets. In certain circumstances, including extremely volatile market conditions, it may be appropriate to apply alternative valuation methods, to more accurately determine the fair market value of our assets, such as a valuation of the assets by an independent qualified expert. We obtained an opinion from a U.S. tax advisor providing the reasoning for adoption of an approach other than the market capitalization approach and applying the results of our valuation study that was conducted by an independent valuator. In view of certain estimates of our gross income and the average value of our gross assets, the latter supported by said third party valuation and opinion, we believe that we should not be a PFIC for the taxable year ended December 31, 2009. There can be no certainty that the U.S. Internal Revenues Service ("IRS") will not challenge such a position, however, and determine that based on the IRS' interpretation of the asset test, we were a PFIC in 2009. Thus, there can be no assurance that we will not be considered a PFIC for 2009 or for any other taxable year. We are not providing any U.S. tax opinion to any U.S. Holder concerning any potential PFIC status of our company, and U.S. Holders should consult their own tax advisors concerning the implication of the PFIC rules in his, her or its particular circumstances. See "ITEM 10: Taxation—United States Federal Income Taxation—Passive Foreign Investment Company Considerations."

If we were characterized as a passive foreign investment company, a U.S. Holder (as defined under "ITEM 10: Additional Information—Taxation—United States Federal Income Taxation—Passive Foreign Investment Company Considerations") could avoid certain adverse passive foreign investment company consequences by making a qualified electing fund election to be taxed currently on its proportionate share of the passive foreign investment company's ordinary income and net capital gains. However, we do not intend to comply with the necessary accounting and record keeping requirements that would allow a U.S. Holder to make a qualified electing fund election with respect to the Company. See "ITEM 10: Additional Information—Taxation—United States Federal Income Taxation—Passive Foreign Investment Company Considerations."

Risks Relating to our Location in Israel

Conditions in Israel could adversely affect our business.

We are incorporated under Israeli law and our principal offices, and research and development facilities are located in Israel. Accordingly, political, economic and military conditions in Israel directly affect our business. Since the State of Israel was established in 1948, a number of armed conflicts have occurred between Israel and its Arab neighbors. In recent years, there has been an escalation in violence among Israel, Hamas, Hezbollah, the Palestinian Authority and other groups. Furthermore, several countries, principally in the Middle East, still restrict doing business with Israel and Israeli companies, and additional countries may impose restrictions on doing business with Israel and Israeli companies if hostilities in Israel continue or increase. These restrictions may limit materially our ability to sell our solutions to companies in these countries. Any hostilities involving Israel or the interruption or curtailment of trade between Israel and its present trading partners, or a significant downturn in the economic or financial condition of Israel, could adversely affect our operations and product development, cause our revenues to decrease and adversely affect the share price of publicly traded companies having operations in Israel, such as us. Additionally, any hostilities involving Israel may have a material adverse effect on either of our principal subcontractors and their facilities in which event, all or a portion of our inventory may be damaged, and our ability to deliver products to customers may be materially adversely affected.

Our operations may be disrupted by the obligations of personnel to perform military service.

As of December 31, 2009, we employed 252 people, of whom 170 were based in Israel. Some of our executive officers and employees in Israel are obligated to perform annual military reserve duty in the Israel Defense Forces, depending on their age and position in the army. Additionally, they may be called to active reserve duty at any time under emergency circumstances for extended periods of time. Our operations could be disrupted by the absence for a significant period of one or more of our executive officers or key employees due to military service, and any significant disruption in our operations could harm our business. The full impact on our workforce or business if some of our executive officers and employees will be called upon to perform military service, especially in times of national emergency, is difficult to predict. Additionally, the absence of a significant number of the employees at either of our principal subcontractors related to military service may disrupt their operations in which event our ability to deliver products to customers may be materially adversely affected.

The tax benefits that are available to us require us to meet several conditions and may be terminated or reduced in the future, which would increase our costs and taxes.

Our investment program in equipment at our facility in Hod-Hasharon, Israel has been granted approved enterprise status and we are therefore eligible for tax benefits under the Israeli Law for the Encouragement of Capital Investments, 1959, referred to as the Investments Law. We expect to utilize these tax benefits after we utilize our net operating loss carry forwards. As of December 31, 2009, our net operating loss carry forwards for Israeli tax purposes amounted to approximately $46 million. To remain eligible for these tax benefits, we must continue to meet certain conditions stipulated in the Investments Law and its regulations and the criteria set forth in the specific certificate of approval, including, among other conditions, that the approved enterprise be operated over a seven-year period and that at least 30% of our investment in fixed assets of the approved enterprise be funded by additional paid-up ordinary share capital. If we do not meet the conditions stipulated in the Investments Law and its regulations and the criteria set forth in the specific certificate of approval in the future, the tax benefits would be canceled and we could be required to refund any tax benefits that we have received. These tax benefits may not be continued in the future at their current levels or at any level.

Effective April 1, 2005, the Investments Law was amended. As a result, the criteria for new investments qualified to receive tax benefits were revised. No assurance can be given that we will, in the future, be eligible to receive additional tax benefits under this law. The termination or reduction of these tax benefits would increase our tax liability in the future, which would reduce our profits or increase our losses. Additionally, if we increase our activities outside of Israel, for example, by future acquisitions, our increased activities might not be eligible for inclusion in Israeli tax benefit programs. See “ITEM 10: Additional Information—Taxation—Israeli Tax Considerations and Government Programs—Law for the Encouragement of Capital Investments, 1959.”

The government grants we have received for research and development expenditures restrict our ability to manufacture products and transfer technologies outside of Israel and require us to satisfy specified conditions. If we fail to comply with such restrictions or these conditions, we may be required to refund grants previously received together with interest and penalties, and may be subject to criminal charges.

We have received royalty-bearing grants from the government of Israel through the Office of the Chief Scientist of the Ministry of Industry, Trade and Labor, for the financing of a portion of our research and development expenditures in Israel, pursuant to the provisions of The Encouragement of Industrial Research and Development Law, 1984, referred to as the Research and Development Law. In 2007, 2008 and 2009, we received and accrued grants totaling $2.4, $2.7 and $2.4 million from the Office of the Chief Scientist, representing 20.2%, 18.3% and 20.8%, respectively, of our gross research and development expenditures in these periods. We may not receive future grants or may receive significantly smaller grants from the Office of the Chief Scientist and our failure to receive grants in the future could adversely affect our profitability.

The terms of the grants prohibit us from manufacturing products outside of Israel or transferring intellectual property rights in technologies developed using these grants inside or outside of Israel without special approvals. Even if we receive approval to manufacture our products outside of Israel, we may be required to pay an increased total amount of royalties, which may be up to 300% of the grant amount plus interest, depending on the manufacturing volume that is performed outside of Israel. This restriction may impair our ability to outsource manufacturing or engage in similar arrangements for those products or technologies. Know-how developed under an approved research and development program may not be transferred to any third parties, except in certain circumstances and subject to prior approval. In addition, if we fail to comply with any of the conditions and restrictions imposed by the Research and Development Law or by the specific terms of under which we received the grants, we may be required to refund any grants previously received together with interest and penalties, and may be subject to criminal charges. In recent years, the government of Israel has accelerated the rate of repayment of the Office of Chief Scientist grants and may further accelerate them in the future.

It may be difficult to enforce a U.S. judgment against us, our officers and directors in Israel or the United States, or to assert U.S. securities laws claims in Israel or serve process on our officers and directors.

We are incorporated in Israel. The majority of our executive officers and directors are not residents of the United States, and the majority of our assets and the assets of these persons are located outside the United States. Therefore, it may be difficult for an investor, or any other person or entity, to enforce a U.S. court judgment based upon the civil liability provisions of the U.S. federal securities laws against us or any of these persons in a U.S. or Israeli court, or to effect service of process upon these persons in the United States. Additionally, it may be difficult for an investor, or any other person or entity, 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 on the grounds that Israel is not the most appropriate forum in which to bring such a claim. 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 the matters described above.

Provisions of Israeli law and our articles of association may delay, prevent or make undesirable an acquisition of all or a significant portion of our shares or assets.

Our articles of association contain certain provisions that may delay or prevent a change of control, including a classified board of directors. In addition, Israeli corporate law regulates acquisitions of shares through tender offers and mergers, requires special approvals for transactions involving significant shareholders and regulates other matters that may be relevant to these types of transactions. These provisions of Israeli law could have the effect of delaying or preventing a change in control and may make it more difficult for a third party to acquire us, even if doing so would be beneficial to our shareholders, and may limit the price that investors may be willing to pay in the future for our ordinary shares. Furthermore, Israeli tax considerations may make potential transactions undesirable to us or to some of our shareholders. See “ITEM 10: Additional Information—Memorandum of Association and Articles of Association—Anti-Takeover Measures” and “—Acquisitions under Israeli Law.”

If the price of our ordinary shares declines, we may be more vulnerable to an unsolicited or hostile acquisition bid.

Notwithstanding provisions of our articles of association and Israeli law, a decline in the price of our ordinary shares may result in us becoming subject to an unsolicited or hostile acquisition bid. In the event that such a bid is publicly disclosed, it may result in increased speculation regarding our company and volatility in our share price even if our board of directors decides not to pursue a transaction. If our board does wish to pursue a transaction, there can be no assurance that it will be consummated successfully or that the price paid will represent a premium above the original price paid for our shares by all of our shareholders. See "ITEM 10: Additional Information—Description of Share Capital—Anti-Takeover Measures" and "—Acquisitions under Israeli Law."

ITEM 4: Information on Allot

A. History and Development of Allot

Our History

Our legal and commercial name is Allot Communications Ltd. We are a company limited by shares organized under the laws of the State of Israel. Our principal executive offices are located at 22 Hanagar Street, Neve Ne'eman Industrial Zone B, Hod-Hasharon 45240, Israel, and our telephone number is +972 (9) 761-9200. We have irrevocably appointed Allot Communications, Inc. as our agent to receive service of process in any action against us in any United States federal or state court. The address of Allot Communications, Inc. is 300 TradeCenter, Suite 4680, Woburn, MA 01801-7422.

We were incorporated in late 1996 as "Ariadne Ltd." and commenced operations in 1997. In September 1997, we changed our name to "Allot Communications Ltd." In 2007, we introduced our Service Gateway platform that enables broadband providers to build efficient, secure, manageable and profitable intelligent networks that are optimized to deliver Internet-based content and services. In January 2008, we completed the acquisition of the business of Esphion Limited, a developer of network protection solutions for carriers and internet service providers.

We paid for capital expenditures of $2.7 million in 2009, $1.7 million in 2008 and $3.5 million in 2007. We have financed our capital expenditures with cash generated through net proceeds from our initial public offering and private placements of our equity securities.

Our capital expenditures during 2007, 2008 and 2009 consisted primarily of investments in lab equipment for research and development, as well as customer support and demo units.

B. Business Overview

Overview

We are a leading provider of intelligent IP service optimization solutions for mobile, DSL and wireless broadband carriers, cable operator service providers, and enterprises. Our portfolio of hardware platforms and software applications utilizes advanced deep packet inspection, or DPI, technology to transform broadband pipes into smart networks that can rapidly and efficiently manage data over mobile and wireline networks and deploy value added Internet services. Our scalable, carrier-grade solutions provide the visibility, security, application control and subscriber management that are vital to managing Internet service delivery, guaranteeing quality of experience, or QoE, containing operating costs, and maximizing revenue in broadband networks.

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Industry Background

The rapid proliferation of broadband networks in recent years has been largely driven by demand from users for faster and more reliable access to the Internet and by the proliferation in the number and complexity of broadband applications, as well as the proliferation of mobile data-enhanced smart phones such as the iPhone.

Rising Network Operational Costs Due to the Rapid Adoption of Broadband Applications

The increasing adoption of broadband access has enabled significant advances in the sophistication of applications delivered over broadband networks. In contrast to traditional applications, such as e-mail and web-browsing, many newer applications, such as P2P, Internet video, online gaming and online content sites, require large amounts of bandwidth and are highly sensitive to network delays. In response to these challenges, service providers have been forced to invest heavily in network infrastructure upgrades and customer support services in order to maintain the quality of experience for subscribers.

Rising Data Traffic in Mobile Networks

The mobile data market is growing very rapidly, with the advent of the iPhone and other data-enhanced handsets, as well as the rise in use of mobile modems in laptop computers (“dongles”) and netbooks. To put this into perspective, the average smartphone user generates multiple times as much data traffic as the non-smartphone user.

The cost of deploying mobile bandwidth at the access point, or the GGSN, in mobile networks is significantly higher than that in wireline networks. As a result, mobile operators are already beginning to feel economic and infrastructure challenges in meeting the rising tide of data traffic over their networks. In addition, as capacity increases in mobile networks, smartphone users will have increased expectations with respect to speed and performance.

It is becoming increasingly apparent that unmanaged 3G, and even 4G mobile networks will not be able to cope with the rising tide of data traffic.

Service Providers Demand for the Ability to Offer Premium and Differentiated Services

Most service providers offer flat-fee broadband access, regardless of the type of applications and data used by subscribers. These operators provide the same level of service to all subscribers and do not guarantee access quality, regardless of a subscriber’s willingness to pay for premium services and network performance. In addition, competition among service providers has increased because of multiple broadband delivery options, such as cable, DSL, wireless and satellite. As a result of these factors, broadband access has become a commodity, contributing to downward price pressure and high churn rates.

To address these issues and increase the average revenue per user, or ARPU, service providers have begun to offer premium, differentiated services, such as improved quality for VoIP and Internet video. By offering such tiered services and charging subscribers according to the value of these services or according to accumulated usage, service providers can capitalize on the revenue enhancement opportunities enabled by broadband applications. To offer premium services and to guarantee service levels for those services, service providers need enhanced visibility into and control of network traffic, including visibility into the type of applications used on the network and levels of traffic generated by different subscribers.

Increasing Enterprise Demand for Visibility and Delivery of Mission-Critical Applications

The proliferation of network applications also presents significant challenges for enterprises operating wide-area networks. Applications such as e-mail, customer relationship management, or CRM, enterprise resource planning and other online transactional and business applications are critical to enterprises' ability to operate efficiently. Enterprises have also become increasingly dependent on broadband Internet and Intranet access, as content distribution between partners and customers, employee remote access, and even VoIP, have become more common. At the same time, the openness of the Internet allows employees to use a wide variety of recreational and non-business applications on enterprise networks, resulting in network congestion and negatively impacting employee productivity. As a result, enterprises have experienced diminished performance of their mission-critical applications.

Network Security Threats

As reliance on the Internet has grown, service providers and subscribers have become increasingly vulnerable to a wide range of security threats, including denial of service attacks. The attacks hinder the ability of service providers to provide high quality broadband access to subscribers, prevent enterprises from using mission-critical applications and compromise network and data integrity. We believe that users increasingly expect service providers to protect them from these threats. Therefore, it has become imperative for service providers and enterprises to identify and block malicious traffic at very early stages.

The Challenge of Implementing Intelligent Networks

Service providers are seeking to transform generic access broadband networks into intelligent broadband networks. The ability to identify, distinguish and prioritize different applications plays a major role in intelligent network management, allowing service providers to optimize bandwidth usage and reduce operational costs, while maintaining high quality of service. Application designers are employing increasingly sophisticated methods to avoid detection by network operators who desire to manage network use. Traditional network infrastructure devices, such as routers and switches, do not generally have sufficient computing resources or the required algorithms to distinguish between different and rapidly evolving applications. The dilemma of implementing intelligent networks is further complicated by today's higher speed broadband networks, which carry tremendous amounts of data and serve millions of customers. Unlike traditional network infrastructure devices, such as switches and routers, which can perform only a very limited examination of packets, DPI solutions offer active management of each application and subscriber in the network requiring significant processing power and speed, greater memory and special algorithms.

The Allot Solution

Our solutions enable service providers to optimize and monetize their wireline and mobile data networks. These solutions employ advanced deep packet inspection, or DPI, which identifies applications by examining the content encapsulated in packets, including header and application information. By correlating data from multiple packets and flows, searching for application signatures and recognizing application behavior, our solutions identify each subscriber and application in the network and provide in-depth, real time information about their behavior. Once an application has been identified, it can be managed using predetermined policies that determine the level of network resources allocated for that application based on the business strategy of the service provider or enterprise. We have developed market-leading DPI technology that accurately identifies hundreds of application protocols at higher speeds and creates customized detailed usage analyses and reports. Our vision is that our technology will become a platform for a range of value-added services, rather than an added feature on a router. Once our DPI engine is able to provide information regarding applications running over the network, we believe our platform will enable service providers to use this information to drive additional revenues by enabling additional functionalities on our DPI platform. In 2008, we acquired the business of Esphion, a developer of network protection solutions for carriers and internet service providers, which increased the scope of our product offering. In 2009, we announced the Allot MediaSwift, a solution designed to save backhaul cost to service providers and to enhance QoE to end users by caching and accelerating popular internet video, and the Allot WebSafe, a network service designed to block access to illegal websites defined by the Internet Watch Foundation (IWF).

Our Products

Traffic Management Systems

Our traffic management systems consist of the Service Gateway platform and the NetEnforcer product line.

The Service Gateway platform is an open standards-based platform for broadband service control and optimization based on DPI. It is based on an AdvancedTCA®-compliant chassis with modular, hot-swappable DPI blades. A single platform provides up to 16 Gigabit Ethernet ports or eight 10 Gigabit Ethernet ports, supporting up to 60 Gigabits per second (Gbps) of throughput. Within the Service Gateway, the application and subscriber information for each traffic flow is identified by a single DPI process that can then dispatch the flow to an array of additional services and actions. These actions may, through additional blades on the platform, include traffic prioritization and Quality of Service, or QoS, optimization, filtering (including parental control), blocking security threats (Clean Line and denial-of-service-prevention), media caching or collecting records for real-time charging or offline usage-based charging.

The Service Gateway is designed to reduce the cost and complexity of developing new services. It increases operation efficiency by enabling service providers to deploy multiple services through a single multi-purpose platform rather than by using multiple single purpose appliances. Using the Service Gateway, service providers are able to manage all services using the same policy control rules and management application. The Service Gateway enables providers to minimize the number of packets handled by each application for all services by leveraging a single DPI process.

The Service Gateway platform also leverages our powerful NetXplorer centralized management software and is fully integrated with our Subscriber Management Platform, described below.

Our NetEnforcer traffic management system inspects, monitors and controls network traffic by application and by user. NetEnforcer devices are positioned at multiple strategic network locations where the most traffic traverses and can be monitored and managed. These locations include network access points, or "peering points," where the network connects to other networks and data centers. NetEnforcer includes its own management software and can also be managed by other vendor management applications through an interface that integrates with the end-customer's operating environment. These applications include policy servers, provisioning systems, customer care and billing applications.

Our traffic management devices are available in several different models to address the needs of a wide range of service providers and enterprises:

Series	Target Market	Operation Speeds	Subscribers(1)
NetEnforcer AC-400	Small to medium enterprise networks and service provider networks	Up to 200 Mbps	Up to 4,000
NetEnforcer AC-800	Medium and large enterprise networks and medium service provider networks	Up to 620 Mbps	Up to 28,000
NetEnforcer AC-1000/ AC-2500	Carrier-class solutions used by medium and large service provider networks	Up to 2 Gbps and 5 Gbps, respectively	Up to 80,000
NetEnforcer AC-1400/ AC-3000	Carrier-class solutions used by large enterprise networks and medium and large service provider networks	Up to 2 Gbps and 8 Gbps, respectively	160,000
NetEnforcer AC-5000	Carrier-class solutions used by medium and large service provider networks with 1G and 10GE networks	Up to 15 Gbps	400,000
NetEnforcer AC-10000	Carrier-class solutions used by medium and large service provider networks with 1G and 10GE networks	Up to 30 Gbps	Up to 800,000
Service Gateway – Omega/Sigma	Carrier-class solutions used by medium and large service provider networks	Up to 60 Gbps	Up to 2,000,000

(1) Represents the maximum number of subscribers that a system can handle simultaneously. Typically, due to network topology, redundancy requirements and other constraints, such as total bandwidth available per subscriber, the actual number per product unit is lower

Our Service Gateway platforms are designed to meet NEBS Level 3 certification requirements to ensure operation in extreme environmental conditions.

Network Management Application Suites

Our network management application suites consist of the NetXplorer management application and the Subscriber Management Platform.

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The NetXplorer management application suite provides service providers and enterprise customers a highly granular, real time view of all traffic on the network. This centralized management suite, works in conjunction with our Service Gateway and NetEnforcer products to provide network traffic intelligence and enable enterprises and service providers to effectively manage broadband services and set policies for the use of their networks. The data provided from multiple systems are aggregated, analyzed and conveyed using our NetXplorer management application suite.

NetXplorer architecture consists of four elements: first, the client element is the NetXplorer graphical user interface application; second, the server element consisting of the actual NetXplorer application, including the database; third, the optional collector element, which assists in collecting large amounts of data from multiple Service Gateways or NetEnforcers; and fourth, an agent element that is an add-on to the Service Gateway or the NetEnforcer that enables them to be managed by the NetXplorer and support all network management functions.

Our Subscriber Management Platform, or SMP, is a scalable system that helps service providers build an intelligent service network designed to deliver the QoE that each subscriber expects, while allowing providers to manage network usage. The SMP monitors subscriber behavior to identify, track and report short- or long-term usage trends. Behavior can be tracked on an individual basis or for groups of subscribers. By analyzing these trends, providers can know which services are the most popular and with whom. This allows the provider to quickly roll out new or packaged services based on individual subscriber demand and preferred delivery. The SMP supports per-subscriber QoS policy definition, enabling providers to rapidly create and deploy tiered service plans that allow different subscribers to have different quality parameters on a per-service basis. This capability, together with the SMP's tiered services control and quota management features, create an opportunity for innovative service packaging and pricing based on individual subscriber demand and preferred delivery. This flexible and customized delivery helps service providers increase ARPU, reduce churn and facilitate the introduction of new revenue-generating services without service interruption.

Value Added Services

ServiceProtector

Our ServiceProtector ensures service continuity and guards network integrity against known and unknown threats. Through immediate identification of Denial of Service (DoS/DDoS) attacks, Zero Day attacks, worms, zombie and spambot behavior, the ServiceProtector enables fast, surgical mitigation by automatically blocking, limiting or isolating only the offending traffic while allowing legitimate traffic to flow. The ServiceProtector's scalable, carrier-grade performance supports up to 10GBPS throughput and is compatible with 1 GE and 10 GE networks.

MediaSwift

The solution synergizes our DPI and caching competences and is designed to save backhaul cost to service providers and to enhance QoE to end users by caching and accelerating popular internet video. MediaSwift is offered as an external solution with our Service Gateway and it is also offered as a solution with other Allot platforms. The MediaSwift is planned to be offered as an internal blade with our Service Gateway.

WebSafe

The solution is a network service designed to block access to illegal websites defined by the Internet Watch Foundation (IWF). At the same time, it allows operators to comply with emerging legislation surrounding online child sexual abuse images and other illegal content. WebSafe is offered as an integrated service within our Service Gateway and it is also offered as a solution with other Allot platforms.

Customers

We have a global, diversified end-customer base consisting primarily of service providers and enterprises. Our direct customers are generally distributors, resellers, OEMs and system integrators, who we refer to as our channel partners. In 2009, we derived 52% of our revenues from Europe, the Middle East and Africa, 26% from Asia and Oceania and 22% from the Americas. We generally only have direct contact with end-customers in the case of larger projects, as smaller projects are driven by our channel partners. In 2009, we had a significant customer which accounted for 15% of our revenues.

Channel Partners

We market and sell our products to end-customers both by direct sales and through our channel partners, which include distributors, resellers, OEMs and system integrators. Our channel partners generally purchase our products from us upon receiving orders from end-customers and are responsible for installing and providing initial customer support for our products. Our channel partners are located around the world and address most major markets. Our channel partners target a range of end-users, including carriers, alternative carriers, cable operators, private networks, data centers and enterprises in a wide range of industries, including government, financial institutions and education. Our agreements with channel partners that are distributors or resellers are generally non-exclusive and are for an initial term of one year and automatically renew for successive one-year terms unless terminated. After the first year, such agreements may be terminated by either party upon ninety days prior notice.

We offer support to our channel partners. This support includes the generation of leads through marketing events, seminars and web-based leads and incentive programs as well as technical and sales training.

Our sales staff's direct contact with end-customers consists mainly of developing leads for our channel partners. A vast majority of our sales occur through our channel partners.

Sales and Marketing

The sales and deployment cycle for our products varies based upon the intended use by the end-customer. The sales cycle for initial network deployment may generally last between one and three years for large and medium service providers, six to twelve months for small service providers, and one to six months for enterprises. Follow-on orders and additional deployment of our products usually require shorter cycles. Large and medium service providers generally take longer to plan the integration of our solutions into their existing networks and to set goals for the implementation of the technology.

We focus our marketing efforts on product positioning, increasing brand awareness, communicating product advantages and generating qualified leads for our sales organization. We rely on a variety of marketing communications channels, including our website, trade shows, industry research and professional publications, the press and special events to gain wider market exposure.

We have organized our worldwide sales efforts into the following three territories: North and South America, Europe the Middle East and Africa, and Asia and Oceania. We have regional offices in the U.S., Israel, France, Spain, United Kingdom, Singapore, Japan and China, and a dedicated regional presence in Germany, Italy, the Czech Republic, India, Hong Kong and Australia. We also maintain a regional presence in Mexico and Brazil.

As of December 31, 2009, our sales and marketing staff, including product management and business development functions, consisted of 57 employees.

Service and Technical Support

We believe our technical support and professional services capabilities are a key element of our sales strategy. Our technical staff assists in presales activities and advises channel partners on the integration of our solutions into end-user networks. Our basic warranty extended to end-customers through our channel partners is three months for software and twelve months for hardware. Generally, end-customers are also offered, through our channel partners, a choice of one year or three-year customer support programs when they purchase our products. These customer support programs can be renewed at the end of their terms. Our end-customer support plans offer the following features:

Ÿ expedited replacement units in the event of a warranty claim; and

Ÿ software updates and upgrades offering new features and addressing new network applications.

Our channel partner support plans are designed to maximize network up-time and minimize operating costs. Our channel partners and their end-customers are entitled to take advantage of our around-the-clock technical support which we provide through our four help desks, located in France, Israel, Singapore and the United States. We also offer our channel partners 24-hour access to an external web-based technical knowledge base, which provides technical support information and enables them to support their customers independently and obtain follow up and support from us. We manage our channel partner and customer support efforts through a single database which enables us to track seamlessly any response provided to a channel partner or end-customer from a different office and to escalate automatically any customer inquiry after a predetermined period of time.

The expenditures associated with the technical support staff are allocated in our statements of operations between sale and marketing expenses and cost of goods sold based on the roles of and tasks performed by personnel.

As of December 31, 2009, our technical staff consisted of 57 employees.

Research and Development

Our research and development activities take place in Israel and New Zealand. As of December 31, 2009, 92 of our employees were engaged primarily in research and development. We devote a significant amount of our resources towards research and development to introduce and continuously enhance products to support our growth strategy. We have assembled a core team of experienced engineers, many of whom are leaders in their particular field or discipline and have technical degrees from top universities and experience working for leading Israeli networking companies. These engineers are involved in advancing our core technologies, as well as in applying these core technologies to our product development activities. Our research and development efforts have benefited from royalty-bearing grants from the Office of the Chief Scientist. The State of Israel does not own any proprietary rights in technology developed with the Office of the Chief Scientist funding and there is no restriction related to the Office of the Chief Scientist on the export of products manufactured using technology developed with Office of the Chief Scientist funding. For a description of restrictions on the transfer of the technology and with respect to manufacturing rights, please see "ITEM 3: Key Information—Risk Factors—The government grants we have received for research and development expenditures restrict our ability to manufacture products and transfer technologies outside of Israel and require us to satisfy specified conditions. If we fail to comply with such restrictions or these conditions, we may be required to refund grants previously received together with interest and penalties, and may be subject to criminal charges."

Manufacturing

We subcontract the manufacture and repair of our legacy NetEnforcer products (AC-400, AC-800, AC-1000 and AC-2500) to R.H. Electronics, an Israeli manufacturer and manufacture and repair of our Service Gateway platforms and our newer NetEnforcer products (AC-1400, AC-3000, AC-5000 and AC-10000) to Flextronics (Israel) Ltd., a subsidiary of Flextronics, a global electronics manufacturing services company. This strategy enables us to reduce our fixed costs, focus on our core research and development competencies and provide flexibility in meeting market demand. R.H. Electronics and Flextronics (Israel) are contractually obligated to provide us with manufacturing services based on agreed specifications, including manufacturing, assembling, testing, packaging and procuring the raw materials for our devices. We are not required to provide any minimum orders. Our agreement with each contractor is automatically renewed annually for additional one-year terms. R.H. Electronics may elect not to renew our agreement with them by giving us at least 90 days prior notice to the expiration of any such term. Furthermore, R.H. Electronics may terminate our agreement at any time during the term upon 120 days prior notice. Flextronics (Israel) may terminate our agreement with them at any time during the term upon 180 days prior notice. We retain the right to procure independently any of the components used in our products. Both contractors have U.S. affiliates to which they can, with the prior consent of the Office of the Chief Scientist, transfer manufacturing of our products if necessary, in which event we may be required to pay increased royalties to the Office of the Chief Scientist. We expect that it would take approximately six months to transition manufacturing of our products to an alternate manufacturer.

We design and develop internally a number of the key components for our products, including printed circuit boards and software. Some of our product's hardware components are obtained from single or limited sources. Since our products have been designed to incorporate these specific components, any change in these components due to an interruption in supply or our inability to obtain such components on a timely basis would require engineering changes to our products before we could incorporate substitute components. In particular, we purchase the central processing unit for our Service Gateway platforms and for our NetEnforcer AC-1400, AC-3000, AC-5000 and AC-10000 from NetLogic Microsystems, Inc. (through the acquisition of Raza Microelectronics, Inc.) and for our NetEnforcer AC-400 and our NetEnforcer AC-800 from Intel Corporation and we have agreed to purchase the network processor for our NetEnforcer AC-1000 and our NetEnforcer AC-2500 from Hifn Inc. We carry approximately three to six months of inventory of key components. We also work closely with our suppliers to monitor the end-of-life of the product cycle for integral components, and believe that in the event that they announce end of life, we will be able to increase our inventory to allow enough time for replacing such components. We do not have a supply agreement with Intel Corporation and the agreements with our other suppliers do not contain any minimum purchase or supply commitments. We have been informed by Hifn that it is their general policy to provide their customers with a six-month last-time-buy option and twelve months to take delivery of the product in the event that Hifn decides to discontinue production of the network processor. Product testing and quality assurance is performed by our contract manufacturer using tests and automated testing equipment and according to controlled test documentation we specify. We also use inspection testing and statistical process controls to assure the quality and reliability of our products.

Competition

Our principal competitors are Cisco Systems (through the acquisitions of P-Cube and Starent Networks, Corp.) and Sandvine in the service provider market, and Blue Coat Systems, Inc. (through its acquisition of Packeteer) in the enterprise market. We also compete with a number of smaller competitors such as CloudShield Technologies, Inc. and Procera Networks, Inc., and we compete indirectly with router and switch infrastructure companies that offer features, which address some of the problems that our products address. We also face competition from companies that offer partial solutions addressing only one aspect of the challenges facing broadband providers, such as network monitoring or security. We compete on the basis of product performance, such as speed and number of applications identified, ease of use and installation, and customer support. Price is also an important, although not the principal, basis on which we compete. See "ITEM 3: Key Information—Risk Factors—We may be unable to compete effectively with other companies in our market who offer, or may in the future offer, competing technologies."

Intellectual Property

Our intellectual property rights are very important to our business. We believe that the complexity of our products and the know-how incorporated in them makes it difficult to copy them or replicate their features. We rely on a combination of confidentiality and other protective clauses in our agreements, copyright and trademarks to protect our know-how. We also restrict access to our servers physically and through closed networks since our product designs and software are stored electronically and thus are highly portable.

We customarily require our employees, distributors, resellers, software testers and contractors to execute confidentiality agreements or agree to confidentiality undertakings when their relationship with us begins. Typically, our employment contracts also include the following clauses: assignment of intellectual property rights for all inventions developed by employees, non-disclosure of all confidential information, and non-compete clauses, which generally restrict the employee for six months following termination of employment. The enforceability of non-compete clauses in certain jurisdictions in which we operate may be limited. Because our product designs and software are stored electronically and thus are highly portable, we attempt to reduce the portability of our designs and software by physically protecting our servers through the use of closed networks, which prevent external access to our servers.

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The communications equipment industry is characterized by constant product changes resulting from new technological developments, performance improvements and lower hardware costs. We believe that our future growth depends to a large extent on our ability to be an innovator in the development and application of hardware and software technology. As we develop the next generation products, we intend to pursue patent protection for our core technologies in the telecommunications segment. We plan to seek patent protection in our largest markets and our competitors' markets, for example in the United States and Europe. As we continue to move into markets, such as Japan, Korea and China, we will evaluate how best to protect our technologies in those markets. We intend to vigorously prosecute and defend the rights of our intellectual property.

As of December 31, 2009, we had two U.S. patents and two pending patent applications in the United States. We expect to formalize our evaluation process for determining which inventions to protect by patents or other means. We cannot be certain that patents will be issued as a result of the patent applications we have filed.

We have obtained U.S. trademark registrations for certain of our key marks that we use to identify our products or services, including "NetEnforcer" and "Allot Communications."

Government Regulation

See "ITEM 5: Overview—Government Grants" for a description of grants received from the Office of the Chief Scientist of the Ministry of Industry, Trade and Labor.

C. Organizational Structure

We conduct our global operations through six wholly-owned subsidiaries: (1) Allot Communications, Inc., headquartered in Woburn, Massachusetts; (2) Allot Communication Europe SARL, headquartered in Sophia, France; (3) Allot Communications Japan K.K., headquartered in Tokyo, Japan; (4) Allot Communication (UK) Limited, headquartered in Guildford, England; (5) Allot Communications (Asia Pacific) Pte. Ltd., headquartered in Singapore; and (6) Allot Communications (New Zealand) Limited, headquartered in Auckland, New Zealand. Our U.S. subsidiary commenced operations in 1997 and engages in the sale, marketing and technical support services in the United States, Canada and Central and Latin America of products manufactured by and imported from our company. Our French, U.K., Japanese and Singapore subsidiaries engage in marketing and technical support services of our products in Europe, Japan and Asia Pacific, respectively. Our New Zealand subsidiary engages in development and technical support services.

D. Property, Plants and Equipment

Our principal administrative and research and development activities are located in a 39,245 square foot (3,646 square meter) facility in Hod-Hasharon, Israel. The lease for this facility commenced in July 2006 and will expire in July 2013. We believe that this facility will be adequate to meet our needs in Israel for at least the next twelve months.

We also lease a 5,862 square foot (545 square meter) facility in Woburn, MA, for the purposes of our U.S. sales and marketing operations pursuant to a lease that expires in August 2014. We lease other smaller facilities for the purpose of our development, sales and marketing and support activities in France, the United Kingdom, Italy, Germany, the Czech Republic, Singapore, Spain, China, Japan and New Zealand.

ITEM 4A: Unresolved Staff Comments

Not applicable.

ITEM 5: Operating and Financial Review and Prospects

A. Operating Results

Overview

We are a leading provider of intelligent IP service optimization solutions for DSL, wireless and mobile broadband carriers, cable operator service providers, and enterprise. Our portfolio of hardware platforms and software applications utilizes advanced DPI technology to transform broadband pipes into smart networks that can rapidly and efficiently manage data over mobile and wireline networks and deploy value added Internet services. End-customers use our solutions to create sophisticated policies to monitor network applications, enforce quality of service policies that guarantee mission-critical application performance, mitigate security risks and leverage network infrastructure investments. Our carrier-class products are used by service providers to offer subscriber-based and application-based tiered services that enable them to optimize their service offerings, reduce churn rates and increase ARPU. We market and sell our products through a variety of channels, including direct sales and through our channel partners, which include distributors, resellers, OEMs and system integrators. End customers of our products include carriers, mobile operators, cable operators, wireless, wireline and satellite Internet service providers, educational institutions, governments and enterprises.

There has been a rapid proliferation of broadband networks in recent years, which has been largely driven by demand from users for faster and more reliable access to the Internet and by the proliferation in the number and complexity of broadband applications. The Internet, which was designed originally to support web surfing and e-mail applications, now supports numerous advanced services, such as interactive gaming and video conferencing. In addition, there has been an exponential increase in over-the-top Internet services, such VoIP and video streaming. These new applications are driving large service providers to explore ways to efficiently manage bandwidth resources in view of these and other bandwidth-heavy applications. As a result, a number of these service providers are considering deploying DPI technology in their networks. We believe that large service providers, as well as cable and mobile operators, present a significant market opportunity and are an important element of our long term strategy.

In 2009, the primary driver of our growth was the mobile market, which was highlighted by our signing a frame agreement towards the end of the second quarter with a global Tier 1 mobile operator group. Revenues in 2009 from this customer accounted for 15% of our total revenues.

Revenues

We generate revenues from two sources: (1) sales of our network traffic management systems and our application suites, and (2) maintenance and support services, including installation and training. We generally provide maintenance and support services pursuant to a one- or three-year maintenance and support program, which may be purchased by customers at the time of product purchase or on a renewal basis.

We recognize revenues from product sales when persuasive evidence of an agreement exists, delivery of the product has occurred, no significant obligations with respect to implementation remain, the fee is fixed or determinable, and collection is probable. We grant a one-year hardware warranty and a three-month software warranty on all of our products and record a liability at the time the product's revenue is recognized. We estimate the liability of possible warranty claims based on our historical experience. Warranty claims have to date been immaterial to our results of operations. Maintenance and support revenues are recognized on a straight line basis over the term of the applicable maintenance and support agreement.. See "—Critical Accounting Policies and Estimates—Revenue Recognition" below.

Customer concentration. In 2009, we derived 15% of our revenues from global Tier 1 mobile operator group. In 2008 and 2007, no single customer accounted for 10% or more of our revenues.

Geographical breakdown. The following table sets forth the geographic breakdown of our revenues for the periods indicated:

	Year Ended December 31,					
	2007		2008		2009	
United States	20		21		15	
Europe	33		33		45	
Asia and Oceania	30		30		26	
Middle East and Africa	6		7		7	
Americas (excluding United States)	11		9		7	
Total	100	%	100	%	100	%

Cost of revenues and gross margins

Our product cost of revenues consists primarily of costs of materials, manufacturing services and overhead, warehousing, testing and royalties paid primarily to the Office of the Chief Scientist of the Israeli Ministry of Industry, Trade and Labor. Our services cost of revenues consist primarily of salaries and related personnel costs for our customer support staff as well as royalty payments mentioned above. We expect cost of revenues to increase as a result of the increase in our product and service revenues, the increased sales of our higher end products, primarily consisting of our Service Gateway platforms and the NetEnforcer AC-10000 and sale of extended service suites to large scale customers that will require additional personnel hiring and other expenditures. This increase may be offset by increased sales of our network management application suites as their direct cost of revenues are expected to be lower. As a result, our gross margins as a percentage of revenues may decrease.

Operating expenses

Research and development. Our research and development expenses consist primarily of salaries and related personnel costs, costs for subcontractor services, depreciation, rent and costs of materials consumed in connection with the design and development of our products. We expense all of our research and development costs as they are incurred. Our net research and development expenses are comprised of gross research and development expenses offset by financing through royalty-bearing grants from the Office of the Chief Scientist. Such participation grants are recognized at the time at which we are entitled to such grants on the basis of the costs incurred and included as a deduction of research and development expenses (See "—Government Grants" below). We believe that significant investment in research and development is essential to our future success and expect that in future periods our research and development expenses will increase on an absolute basis.

Sales and marketing. Our sales and marketing expenses consist primarily of salaries and related personnel costs, travel expenses, costs associated with promotional activities such as public relations, conventions and exhibitions, rental expenses, depreciation and commissions paid to third parties. We intend to continue our activities to target the service provider market and therefore we expect that sales and marketing expenses will increase on an absolute basis in the future as we hire additional sales, marketing and presale support personnel, continue to promote our brand, establish marketing channels and expand our presence worldwide.

General and administrative. Our general and administrative expenses consist of salaries and related personnel costs, rental expenses, costs for professional services and depreciation. We expect these expenses to increase on an absolute basis as we hire additional personnel and incur additional costs related to the growth of our business as we increase our global presence. General and administrative expenses also include costs associated with corporate governance, tax compliance, compliance with the rules implemented by the U.S. Securities and Exchange Commission and NASDAQ, premiums for our director and officer liability insurance and for defending the class action lawsuit filed against us and certain of our directors and officers. See "ITEM 8: Financial Information—Consolidated Statements and Other Financial Information—Legal Proceedings."

Financial expenses, net

Financial expenses, net consists primarily of interest earned on our cash balances and other financial investments, foreign currency exchange gains or losses, devaluation of marketable securities and bank fees.

As of December 31, 2009, we held $27.9 million of principal invested in ARS, which were rated AAA and AA at the time of purchase. Due to the continued deterioration of, and uncertainties in, the credit and capital markets, our ARS have experienced multiple failed auctions due to a lack of liquidity in the market. A number of our ARS have had their credit rating downgraded. To date, our ARS have paid all their interest payments. Based on an analysis of their fair value, we have recorded in 2009 an impairment charge, of $3.0 million to financial and other expenses, net, in our statement of operations with respect to devaluation, which is considered "other than temporary." If the credit and capital markets further deteriorate or we experience any additional ratings downgrades on any ongoing investments in our portfolio, including of ARS, we may incur additional impairments to our investment portfolio and record further impairment charges to our financial and other expenses, net, in our statement of operations. See "—Critical Accounting Policies and Estimates— Marketable Securities" below.

In addition, the financial and other income (expenses), net, may fluctuate due to foreign currency exchange gains or losses, as well as the interest rate changes. See "ITEM 11: Quantitative and Qualitative Disclosures About Market Risk – Foreign Currency Exchange Risk" and – Risk of Interest Rate Fluctuation."

Approved and Privileged Enterprise

Our facilities in Hod-Hasharon, Israel have been granted Approved Enterprise status under the Investments Law and enjoy certain tax benefits. We expect to utilize these tax benefits after we utilize our net operating loss carry forwards. As of December 31, 2009, our net operating loss carry forwards for Israeli tax purposes amounted to approximately $46 million. Income derived from other sources, other than the "Approved Enterprise," during the benefit period will be subject to tax at the regular corporate tax rate. For more information about the tax benefits available to us as an Approved and Privileged Enterprise see "ITEM 10: Additional Information—Taxation and Government Programs—Law for the Encouragement of Capital Investments, 1959."

Government Grants

Our research and development efforts have been financed, in part, through grants from the Office of the Chief Scientist under our approved plans in accordance with the Israeli Law for Encouragement of Research and Development in the Industry, 1984, or the Research and Development Law. Through December 31, 2009, we had received approval and recorded in our books grants totaling $19.2 million from the Office of the Chief Scientist, excluding $4.1 million attributed to NetReality products. Under Israeli law and the approved plans, royalties on the revenues derived from sales of all of our products are payable to the Israeli government, generally at the rate of 3.0% during the first three years and 3.5% beginning with the fourth year, up to the amount of the received grants as adjusted for fluctuation in the U.S. dollar/shekel exchange rate. The amounts received after January 1, 1999 bear interest at twelve month LIBOR as at the beginning of the year in which a grant is approved. Our obligation to pay these royalties is contingent upon actual consolidated sales of our products and no payment is required if no sales are made. As of December 31, 2009, we had an outstanding contingent obligation to pay royalties in the amount of $10.4 million.

The government of Israel does not own proprietary rights in knowledge developed using its funding and there is no restriction related to such funding on the export of products manufactured using the know-how. The know-how is, however, subject to other legal restrictions, including the obligation to manufacture the product based on the know-how in Israel and to obtain the Office of the Chief Scientist's consent to transfer the know-how to a third party, whether in or outside Israel. These restrictions may impair our ability to outsource manufacturing or enter into similar arrangements for those products or technologies and they continue to apply even after we have paid the full amount of royalties payable for the grants.

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If the Office of the Chief Scientist consents to the manufacture of the products outside Israel, the regulations allow the Office of the Chief Scientist to require the payment of increased royalties, ranging from 120% to 300% of the amount of the grant plus interest, depending on the percentage of foreign manufacture. If the manufacturing is performed outside of Israel by us, the rate of royalties payable by us on revenues from the sale of products manufactured outside of Israel will increase by 1% over the regular rates. If the manufacturing, marketing and distribution is carried outside of Israel, the rate of royalties payable by us on those revenues will be calculated in accordance with the proportion between the grant received and the grant plus the amount of our own investments in research and development for such technology. The Research and Development Law further permits the Office of the Chief Scientist, among other things, to approve the transfer of manufacturing or manufacturing rights outside Israel in exchange for an import of certain manufacturing or manufacturing rights into Israel as a substitute, in lieu of the increased royalties.

The Research and Development Law provides that the consent of the Office of the Chief Scientist for the transfer outside of Israel of know-how derived out of an approved plan may only be granted under special circumstances and subject to fulfillment of certain conditions specified in the Research and Development Law as follows: (a) the grant recipient pays to the Office of the Chief Scientist an amount based on the scope of the support received, the royalties that were paid by the company, the amount of time that elapsed since the date on which the grants were received, and the sale price (according to certain formulas), except if the grantee receives from the transferee of the know-how an exclusive, irrevocable, perpetual unlimited license to fully utilize the know-how and all related rights; (b) the grant recipient receives know-how from a third party in exchange for its Office of the Chief Scientist funded know-how; or (c) such transfer of Office of the Chief Scientist funded know-how arises in connection with certain types of cooperation in research and development activities.

In September 2002, we acquired the assets of NetReality, an Israeli manufacturer, from a receiver pursuant to a court ruling. In connection with the NetReality acquisition, we assumed a commitment to pay royalties to the Office of the Chief Scientist up to the amount of the contingent liabilities derived from the grants that had been received by NetReality prior to the acquisition. Following the acquisition of NetReality, the Office of the Chief Scientist merged the NetReality approved plans with our other approved plans under a unified file. In April 2007, the Office of the Chief Scientist notified us of its decision, per our request, to separate the NetReality related approved plans from other approved plans. The Office of the Chief Scientist also approved the discontinuation of the NetReality related approved plans and as a result we were released from the obligation to pay the balance of the royalties in the amount of $4.7 million.

Factors Affecting Our Performance

Our business, financial position and results of operations, as well as the period-to-period comparability of our financial results, are significantly affected by a number of factors, some of which are beyond our control, including:

Size of end-customers and sales cycles. We have a global, diversified end-customer base consisting primarily of service providers and enterprises. We are making efforts to increase our sales to large service providers. The deployment of our products by small and midsize enterprises and service providers can be completed relatively quickly with a limited number of NetEnforcer and/or Service Gateway systems compared to the number required by large service providers. Large service providers take longer to plan the integration of our solutions into their existing networks and to set goals for the implementation of the technology. Sales to large service providers are therefore more complicated as they involve a relatively larger number of network elements and solutions, as well as NetEnforcer and/or Service Gateway systems. We are seeking to achieve further significant customer wins in the large service provider market that would positively impact our future performance. However, our performance is also influenced by sales cycles for our products, which typically fluctuate based upon the size and needs of end-customers that purchase our products. We expect that increased sales to large service providers of Service Gateway platforms will result in longer sales cycles that will increase unpredictability regarding the timing of our sales and may cause our quarterly and annual operating results to fluctuate if a significant customer delays its purchasing decision and/or defers an order. Furthermore, longer sales cycles may result in delays from the time we increase our operating expenses and make investments in inventory, until the time that we generate revenue from related product sales.

Average selling prices. Our performance is affected by the selling price of our products. We price our products based on several factors, including manufacturing costs, the stage of the product’s life cycle, competition, technical complexity of the product, discounts given to channel partners in certain territories, customization and other special considerations in connection with larger projects. We typically are able to charge the highest price for a product when it is first introduced to the market. We expect that the average selling prices for our products will decrease over the product’s life cycle as our competitors introduce new products and DPI technology becomes more standardized. In order to maintain or increase our current price, we expect that we will need to enhance the functionality of our existing products by offering higher system speeds, additional value added services and features, such as additional security functions, supporting additional applications and enhanced reporting tools. We also from time to time introduce enhanced products, typically higher end models that include new architecture and design and new capabilities, primarily to higher end models. Such enhanced products typically increase our average selling price. To further offset such declines, we sell maintenance and support programs on our products, and as our customer base and number of field installations grow our related service revenues are expected to increase.

Cost of revenues and cost reductions. Our cost of revenues as a percentage of total revenues was 24.7% for 2007, 26.1% for 2008 and 28.3% for 2009. Our products use off-the-shelf components and typically the prices of such components decline over time. However, the introduction and sale of new or enhanced products and services may result in an increase in our costs of revenues. We make a continuous effort to identify cheaper components of comparable performance and quality. We also seek improvements in engineering and manufacturing efficiency that will reduce costs. Since our cost of revenues also include royalties paid to the Office of the Chief Scientist, our cost of sales may be impacted positively or negatively by actions of the Israeli government changing the royalty rate. Our products incorporate features that require payment of royalties to third parties. In addition, new products, such as the Service Gateway series, usually have higher costs during the initial introduction period. We generally expect such costs to decline as the product matures and sales volume increases. Introduction of new products may also involve a significant decrease in demand for older products. Such a decrease may result in a devaluation or write-off of such older products and their respective components. In 2009, we recorded a write-off of $0.8 million of inventory to our cost of revenues for products and components, out of which $0.3 million is attributable to components that became obsolete due to the introduction of new products. The growth of our customer base is usually coupled with increased service revenues primarily resulting from increased maintenance and support. In addition, the growth in our installed base with large service providers may result in increased demand for professional services such as training and installation services. Increase in demand for such services may require us to hire additional personnel and incur other expenditures. However, these additional expenses, handled efficiently, may be utilized to further support the growth of our customer base and increase service revenues.

Currency exposure. A majority of our revenues and a substantial portion of our expenses are denominated in the U.S. dollar. However, a significant portion of the expenses associated with our global operations, including personnel and facilities related expenses, are incurred in currencies other than the U.S. dollar. This is the case primarily in Israel and to a lesser extent in other countries in Europe and Asia. Consequently, a decrease in the value of the U.S. dollar relative to local currencies will increase the dollar cost of our operations in these countries. A relative decrease in the value of the U.S. dollar would be partially offset to the extent that we generate revenues in such currencies. In order to partially mitigate this exposure we made in the past and may decide from time to time to enter into hedging transactions. We may discontinue hedging activities at any time. As such decisions involve substantial judgment and assessments primarily regarding future trends in foreign exchange markets which are very volatile as well as our future level and timing of cash flows of these currencies, we cannot provide any assurance that such hedging transactions will not affect our results of operations when they are materialized. See Note 14 to our consolidated financial statements for further information.

Interest rates exposure. We have a significant amount of cash that is currently invested primarily in interest bearing vehicles, such as bank time deposits, money market funds, U.S. government treasury bills and ARS. These investments expose us to the risk of changes in interest rates.

Critical Accounting Policies and Estimates

The preparation of financial statements in conformity with U.S. generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets, liabilities, revenues and expenses and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. These estimates and judgments are subject to an inherent degree of uncertainty and actual results may differ. Our significant accounting policies are more fully described in Note 2 to our consolidated financial statements included elsewhere in this annual report. Certain of our accounting policies are particularly important to the portrayal of our financial position and results of operations. In applying these critical accounting policies, our management uses its judgment to determine the appropriate assumptions to be used in making certain estimates. Those estimates are based on our historical experience, the terms of existing contracts, our observance of trends in our industry, information provided by our customers and information available from other outside sources, as appropriate. With respect to our policies on revenue recognition and warranty costs, our historical experience is based principally on our operations since we commenced selling our products in 1998. Our estimates are primarily guided by observing the following critical accounting policies:

Revenue Recognition

Allowance for Doubtful Accounts
Stock Based Compensation
Inventories
Marketable Securities
Impairment of Goodwill and other Long Lived Assets
Contingencies

Since each of the accounting policies listed above, require exercise of certain judgment and use of estimates, actual results may differ from our estimations and as a result would increase or decrease our future revenues and net income.

Revenue recognition. We generate revenues primarily from the sale of hardware and software products and from the provision of maintenance and support services. We sell our products primarily through resellers, distributors, OEMs, system integrators and value added resellers, all of whom are considered end-customers from our perspective. We recognize revenues from sales of our products in accordance with the Accounting Standards Codification No. 985-605 (formerly, Statement of Position SOP 97-2). When an arrangement does not require significant production, modification or customization of software or does not contain services considered to be essential to the functionality of the software, revenue is recognized when the following four criteria are met: (i) persuasive evidence of an arrangement exists; (ii) delivery has occurred; (iii) the fee is fixed and determinable; and (iv) collection is probable.

Many of our product sales include multiple elements. Such elements typically include several or all of the following: hardware, software licenses, hardware and software maintenance, technical support and training services. For multiple-element arrangements that do not involve significant modification or customization of the software and do not involve services that are considered essential to the functionality of the software, we use the residual method to allocate value to each element when sufficient specific objective evidence exists for all undelivered elements, but does not exist for the delivered element, typically the hardware appliance and software license. Under the residual method, each undelivered element is allocated with a value based on vendor specific objective evidence of fair value for that element and the remainder of the total arrangement fee is allocated to the delivered element(s).

Maintenance and support revenue, including any portion deferred from multiple element arrangements based on the principles mentioned above are recognized on a straight-line basis over the term of the applicable maintenance and support agreement.

We provide a provision for sales incentives, product returns and stock rotation based on the specific arrangements, if any, and our experience with historical sales returns, stock rotations and other known factors, in accordance with Accounting Standards Codification No. 605, “Revenues Recognition When Right of Return Exists”, formerly known as Statement of Financial Accounting Standard No. 48 (“ASC No. 605”) at the time the related revenue is recognized.

We grant a one-year hardware warranty and three-month software warranty on all of our products. We estimate the costs that may be incurred under our warranty arrangements and record a liability in the amount of such costs at the time product revenue is recognized. We periodically assess the adequacy of the recorded warranty liabilities and adjust the amounts as necessary.

Allowance for Doubtful Accounts. We evaluate the collectability of our accounts receivable on a specific basis. We estimate this allowance based on our judgment as to our ability to collect outstanding receivables. We primarily base this judgment on an analysis of significant outstanding invoices, the age of the receivables, our historical collection experience and current economic trends. In circumstances where we are aware of a specific customer's inability to meet its financial obligations to us, we record a specific allowance against amounts due to reduce the net recognized receivable to the amount we reasonably believe will be collected.

Accounting for Stock-Based Compensation. We account for stock based compensation in accordance with ASC No. 718. ASC No. 718 requires companies to estimate the fair value of equity-based payment awards on the date of grant using an option-pricing model. The value of the portion of the award that is ultimately expected to vest is recognized as an expense over the requisite service periods in the Company's Consolidated Statement of Operations. We recognize compensation expenses for the value of its awards granted based on the straight-line method over the requisite service period of each of the awards, net of estimated forfeitures. ASC No. 718 requires forfeitures to be estimated at the time of the grant and revised, if necessary, in subsequent periods if actual forfeitures differ from those estimates. We applies ASC No. 718 and Accounting Standards Codification No. 505-50 (formerly, EITF No. 96-18), "Equity-Based Payments to Non-Employees" ("ASC No. 505-50") with respect to options and warrants issued to non-employees. Accordingly, option valuation models to measure the fair value of the options and warrants at the measurement date as defined in ASC No. 505-50.

We recognize compensation expenses for the value of awards granted based on the straight-line method over the requisite service period of each of the awards, net of estimated forfeitures. ASC No. 718 requires forfeitures to be estimated at the time of the grant and revised, if necessary, in subsequent periods if actual forfeitures differ from those estimates.

On May 18, 2009, we granted 343,297 new options in exchange for 381,440 of our employees' stock options, previously granted on ten occasions during the years 2006-2008. We accounted for the exchange of options under the provisions of ASC No. 718 as a modification. As a result of the modification, our incremental compensation cost of $0.1 million will be recognized over the new service period beginning on the modification date. The unrecognized compensation cost remaining from the original grant date valuation in the amount of $0.6 million shall be recognized over the remainder of the original requisite period. For the year ended on December 31, 2009, we recorded an additional expense of $16,000 in our consolidated statements of operations with respect of this modification.

In connection with the grant of options, we recorded total stock-based compensation expense of $1.4 million in 2007, $1.7 million in 2008 and $2.3 million in 2009. In 2009, $0.1 million, $0.3 million, $0.8 million and $1.0 of our stock-based compensation expense resulted from cost of revenue, research and development expenses, sales and marketing expenses and general and administrative expenses, respectively, based on the department in which the recipient of the option grant was employed. As of December 31, 2009, we had an aggregate of $3.0 million of deferred unrecognized stock-based compensation remaining to be recognized. We estimate that this deferred unrecognized stock-based compensation balance will be amortized as follows: $1.7 million in 2010, $0.8 million in 2011 and $0.5 million in 2012 and thereafter

Inventories. We value our inventories at the lower of cost or estimated market value. Cost being determined on the basis of First In, First Out (“FIFO”) cost method for raw materials and out-of-pocket manufacturing costs. Indirect costs are allocated on average basis. We estimate market value based on our current pricing, market conditions and specific customer information. We write off inventory for slow-moving items or technological obsolescence. We also assess our inventories for obsolescence based upon assumptions about future demand and market conditions. Actual future results may differ from our assessments and result in further devaluations or write-downs that will affect our future results of operations. Once inventory is written off, a new cost basis for these assets is established for future periods. Inventory write offs totaled $0.2 million in 2007, $0.2 million in 2008 and $0.8 million in 2009. The write-offs we incurred in 2009 consist of a $0.5 million write-off of old products that based on our estimation have become obsolete due to introduction of newer products.

Marketable securities. We account for our investments in marketable securities using Accounting Standards Codification No. 320 (formerly, Statement of Financial Accounting Standard No. 115), “Investments – Debt and Equity Securities” (“ASC No. 320”).

We determine the appropriate classification of marketable securities at the time of purchase and evaluate such designation as of each balance sheet date. We classify all of our marketable securities as available for sale. Available for sale securities are carried at fair value, with the unrealized gains and losses, reported in “accumulated other comprehensive income (loss)” in shareholders’ equity. Realized gains and losses on sale of investments are included in earnings and are derived using the specific identification method for determining the cost of securities. The amortized cost of debt securities is adjusted for amortization of premiums and accretion of discounts to maturity. Such amortization together with interest and dividends on securities are included in financial income, net, if any.

Until 2009, we recognized an impairment charge when a decline in the fair value of our investments below the cost basis is judged to be other-than-temporary. The entire difference between amortized cost and fair value is recognized in earnings. Factors considered in making such a determination include the duration and severity of the impairment, the reason for the decline in value and the potential recovery period.

In April 2009, we adopted the FASB’s updated guidance relating to investments and debt securities, which amends the other-than-temporary impairment ("OTTI") guidance in U.S. GAAP. Under the updated guidance, if other-than-temporary impairment occurs, and it is more likely than not that we will not sell the investment or debt security before the recovery of its amortized cost basis, then the other-than-temporary impairment is separated into (a) the amount representing the credit loss and (b) the amount related to all other factors. The amount of the total other-than-temporary impairment related to credit loss is recognized in earnings. The amount of the total other-than-temporary impairment related to other factors is recognized in accumulated other comprehensive income. As a result of the adoption of this update accounting guidance, we recorded a cumulative effect adjustment of $7,7 million to reclassify the non-credit component of previously recognized impairments from accumulated deficit to accumulated other comprehensive income (loss). See Note 4 to our consolidated financial statements for further information .

As of December 31, 2009, we held marketable securities in U.S. dollars in the United States. Securities consisting of ARS were classified as long term investments. We hold ARS with par value of $27.9 million that bear interest linked to LIBOR. We determined the fair value of the ARS as of December 31, 2009, at $14.5 million, based on a third party valuation using a discounted cash flow model for each security, whose inputs and assumptions include the market conditions related to such security as well as the underlying structure of the security, the financial standing of the issuer, stated maturities, estimates of the probability of the issue being called at par prior to final maturity, estimates of the probability of defaults and recoveries, auctions failure and successful auction or repurchase at par for each period, expected changes in interest rates paid on the securities, interest rates paid on similar instruments. During 2009, we recorded an impairment charge of $3.0 million in our statement of operations as a result of a further devaluation related to credit losses. In addition, during 2009 we recorded an unrealized gain of $2.2 million to other comprehensive income in our balance sheet for appreciation of certain ARS in our portfolio. See "ITEM 3: Key Information—Risk Factors—We have invested a substantial portion of our cash in auction-rate securities, which subjects us to liquidity and investment risk. Due to uncertainties in the capital markets regarding auction-rate securities, we recorded impairment charges in 2007, 2008 and 2009, and, if the fair value of these investments were to decline further, we could be required to record further impairment charges related to these investments." If the fair value of these ARS was to decline further, we could be required to record further impairment charges related to these ARS in the future.

Impairment of Goodwill and Long Lived Assets. Goodwill represent the excess of the purchase price over the fair value of net assets of purchased businesses is recorded as goodwill. Under Accounting Statement Codification No. 350, formerly known as Statement of Accounting Standards No. 142, "Goodwill and Other Intangible Assets" ("ASC No. 350") goodwill and intangible assets deemed to have indefinite lives are tested for impairment annually, or more often if there are indicators to impairment present.

We perform our annual impairment analysis of goodwill as of December 31 of each year, or more often as applicable. The provisions of ASC No. 350 require that a two-step impairment test be performed on goodwill at the level of the reporting units. In the first step, or Step 1, we compare the fair value of each reporting unit to its carrying value. If the fair value exceeds the carrying value of the net assets, goodwill is considered not impaired, and we are not required to perform further testing. If the carrying value of the net assets exceeds the fair value, then we must perform the second step, or Step 2, of the impairment test in order to determine the implied fair value of goodwill. If the carrying value of goodwill exceeds its implied fair value, then we would record an impairment loss equal to the difference. If and when we are required to perform a Step 2 analysis, determining the fair value of its net assets and its off-balance sheet intangibles would require it to make judgments that involve the use of significant estimates and assumptions.

We believe that our business activity and management structure meet the criterion of being a single reporting unit for accounting purposes.

Our long lived assets consist primarily of property and equipment and other intangible assets. Our long lived assets are amortized using the straight-line basis over their estimated useful lives. The carrying amount of these assets to be held and used is reviewed whenever events or changes in circumstances indicate that the carrying value of an asset may not be recoverable. Recoverability of these assets is measured by comparison of the carrying amount of the asset to the future undiscounted cash flows the asset is expected to generate. If the asset is considered to be impaired, the amount of any impairment is measured as the difference between the carrying value and the fair value of the impaired asset. As this test requires considerable judgment and estimation of future cash flows, changes in these estimations may affect our results of operations significantly. Based on the impairment test performed as of December 31, 2009, no impairment was identified.

Contingencies. From time to time, we are defendant or plaintiff in various legal actions, which arise in the normal course of business. We are required to assess the likelihood of any adverse judgments or outcomes to these matters as well as potential ranges of probable losses. A determination of the amount of reserves required for these contingencies, if any, which would impact our results of operations, is made after considered analysis of each individual action together with our legal advisors. The required reserves may change in the future due to new developments in each matter or changes in circumstances and estimations. A change in the required reserves would impact our results of operations in the period the change is made.

Recent Accounting Pronouncements

In April, 2009, we adopted the FASB's updated guidance Accounting Standards Codification No. 820-10 (formerly, FSP No.157-04), related to fair value measurements and disclosures, which provides additional guidance for estimating fair value in accordance with the guidance related to fair value measurements when the volume and level of activity for an asset or liability have significantly decreased. The updated standard also includes guidance on identifying circumstances that indicate a transaction is not orderly. We adopted this standard effective April 1, 2009. The adoption of this guidance did not have a material effect on the consolidated financial statements.

In May 2009, the FASB issued Accounting Standards Codification No. 855 (formerly, FASB Statement No.165), "Subsequent Events" ("ASC No. 855"). This standard is intended to establish general standards of accounting for and disclosures of events that occur after the balance sheet date but before financial statements are issued or are available to be issued. Specifically, this standard sets forth the period after the balance sheet date during which management of a reporting entity should evaluate events or transactions that may occur for potential recognition or disclosure in the financial statements, the circumstances under which an entity should recognize events or transactions occurring after the balance sheet date in its financial statements, and the disclosures that an entity should make about events or transactions that occurred after the balance sheet date. ASC No. 855 is effective for fiscal years and interim periods ended after June 15, 2009. We adopted this standard effective June 15, 2009. The adoption of this guidance did not have a material effect on our consolidated financial statements.

In June 2009, the FASB issued a standard that established the FASB Accounting Standards Codification ("ASC") and amended the hierarchy of generally accepted accounting principles ("GAAP") such that the ASC became the single source of authoritative U.S. GAAP. Rules and interpretive releases issued by the SEC under authority of federal securities law are also sources of the authoritative GAAP for SEC registrants. All other literature is considered non-authoritative. New accounting standards issued subsequent to June 30, 2009 are communicated by the FASB through Accounting Standards Updates ("ASUs"). The ASC is effective for the Company from September 1, 2009. Throughout the notes to the consolidated financial statements references that were previously made to former authoritative U.S. GAAP pronouncements have been changed to coincide with the appropriate section of the ASC.

In October 2009, the FASB issued an update to ASC No. 985-605, “Software-Revenue Recognition” (originally issued as EITF 09-3). In accordance with the update to the ASC, tangible products containing software components and non-software components that function together to deliver the tangible product's essential functionality are excluded from the scope of the software revenue recognition guidance. In addition, hardware components of a tangible product containing software component are always excluded from the software revenue guidance. The mandatory adoption is on January 1, 2011, with earlier adoption permitted. We may elect to adopt the update prospectively, to new or materially modified arrangements beginning on the adoption date, or retrospectively, for all periods presented. We currently evaluating the impact on its consolidated results of operations and financial condition, and has not yet determined the adoption date.

In October 2009, the FASB issued an update to ASC No. 605-25, “Revenue recognition – Multiple-Element Arrangements,” that provides amendments to the criteria for separating consideration in multiple-deliverable arrangements to:

provide updated guidance on whether multiple deliverables exist, how the deliverables in an arrangement should be separated, and how the consideration should be allocated;

require an entity to allocate revenue in an arrangement using estimated selling prices (“ESP”) of deliverables if a vendor does not have vendor-specific objective evidence of selling price (“VSOE”) or third-party evidence of selling price (“TPE”); and

eliminate the use of the residual method and require an entity to allocate revenue using the relative selling price method.

require expanded disclosures of qualitative and quantitative information regarding application of the multiple-deliverable revenue arrangement guidance.

We may elect to adopt the update prospectively, to new or materially modified arrangements beginning on the adoption date, or retrospectively, for all periods presented. We currently evaluating the impact on its consolidated results of operations and financial condition, and has not yet determined the adoption date

Results of Operations

The following table sets forth our statements of operations as a percentage of revenues for the periods indicated:

	Year ended December 31,		
	2007	2008	2009
Revenues:			
Products	77.1 %	73.1 %	71.0 %
Services	22.9	26.9	29.0
Total revenues	100.0	100.0	100.0
Cost of revenues:			
Products	20.3	22.1	24.2
Services	4.4	4	4.2
Total cost of revenues	24.7	26.1	28.4
Gross profit	75.3	73.9	71.6
Operating expenses:			
Research and development, net	28.9	32.2	22.1
Sales and marketing	55.6	53.3	48.9

General and administrative	17.2	16.6	13.3
In Process Research and Development	-	0.7	-
Total operating expenses	101.7	102.8	84.3
Operating loss	(26.4)	(28.9)	(12.7)
Financing and other income (expenses), net	(2.6)	(14.9)	(5.5)
Loss before income tax benefit (expense)	(29.0)	(43.9)	(18.2)
Income tax expense	1.6	0.6	0.1
Net income (loss)	(30.6)	(44.5)	(18.3)

Year Ended December 31, 2009 Compared to Year Ended December 31, 2008

Revenues

Products. Product revenues increased by $2.5 million, or 9%, to $29.6 million in 2009 from $27.1 million in 2008. The increase is primarily attributable to increased sales of our high-end products, primarily the Service Gateway platforms, driven by the agreement we signed with a global Tier 1 mobile operator group. This increase was partially offset by a decrease in sales of our low-end products.

Services. Service revenues increased by $2.1 million, or 21.3%, to $12.1 million in 2009 from $10 million in 2008. The increase in service revenues is primarily attributable to an increase in our installed base.

Product revenues, which comprised 71% of our total revenues in 2009, decreased by 2.1% compared to 2008, while service revenues increased by a similar percentage.

During 2009, revenues in Europe increased by $6.5 million or 53.3% compared to 2008, which was primarily attributable to an agreement signed with a global Tier 1 mobile operator group. Revenues in the Americas decreased by $1.9 million or 17% compared to 2008. Revenues in Asia and Oceania decreased by $0.2 million or 2% compared to 2008. Revenues in the Middle East and Africa increased by $0.2 million or 9% compared to 2008.

Cost of revenues and gross margin

Products. Cost of product revenues increased by $1.9 million, or 23%, to $10 million in 2009 from $8.2 million in 2008. This increase is consistent with the increase in product revenues. Product gross margin decreased to 65.9% in 2009 from 69.7% in 2008. This decrease is primarily attributable to higher sales volume of our high-end products, which require higher material and labor costs as well as an increased inventory write-off, of which $0.5 million is attributable to the introduction of new products in 2009.

Services. Service cost of revenues increased by $0.2 million, or 16.2 %, to $1.7 million in 2009 from $1.5 million in 2008. This increase is primarily attributable to higher support personnel expenses. Services gross margin increased to 85.6 % in 2009 from 85.0% in 2008.

Total gross margin decreased to 71.6% in 2009 from 73.9% in 2008. This decrease is primarily attributable to the decrease in product gross margin as described above.

Operating expenses

Research and development. Gross research and development expenses decreased by $2.9 million, or 19.8%, to $11.7 million in 2009 from $14.6 million in 2008. This decrease is primarily attributable to a decrease in salaries and labor costs of approximately $2.7 million, which principally resulted from efficiency measures taken by management, consisting primarily of a salary reduction and certain reductions in force at the beginning of the year, as well as appreciation of the U.S. dollar relative to the shekel and decrease of $0.2 million in maintenance car, which resulted from reduction in car leasing.

Research and development expenses, net of received and accrued grants from the Office of the Chief Scientist, decreased by approximately $2.7 million, or 22.5%, to $9.3 million in 2009 from $12.0 million in 2008. Grants received from the Office of the Chief Scientist totaled $2.4 million in 2009 compared to $2.7 million in 2008. The decrease in grants received is primarily attributable to the appreciation of U.S. dollar relative to the shekel. Research and development expenses, net, as a percentage of revenues decreased to 22.2% in 2009 from 32.2% in 2008.

Sales and marketing. Sales and marketing expenses increased by $0.6 million, or 3.2%, to $20.4 million in 2009 from $19.8 million in 2008. This increase is primarily attributable to increased commissions of approximately $0.5 million, increased stock based compensation expenses of approximately $0.3 million, increased travel expenses of approximately $0.5 million, both resulting from increased sales, increased depreciation primarily attributable to write-off of old demonstration units of approximately $0.4 million due to the introduction of new products, partially offset by $1.1 million attributable to decrease in salaries and related expenses, primarily related to salary reduction, appreciation of the U.S. dollar relative to the shekel and a decrease in the average level of employees compared to 2008.

Sales and marketing expenses, as a percentage of revenues decreased to 48.9% in 2009 from 53.3% in 2008.

General and administrative. General and administrative expenses decreased by $0.7 million, or 10.3%, to $5.5 million in 2009 from $6.2 million in 2008. This decrease is primarily attributable to a decrease of approximately $0.4 million in salaries and related expenses primarily due to salary reduction and appreciation of the U.S. dollar relative to the shekel, decrease of $0.1 million in insurance expenses and a decrease of variable overhead and personnel expenses of approximately $0.4 million, partially offset by an increase of $0.2 million stock-based compensation expenses.

General and administrative expenses as a percentage of revenues decreased to 13.2% in 2009 from 16.6% in 2008.

Financial and other income (expenses), net. Financial and other expenses, net decreased by $3.2 million to $2.3 million in 2009 from $5.5 million in 2008. The decrease in financial and other expenses, net is primarily attributable to a decrease in net impairment charge of $4.7 related to our investment in ARS and a decrease of $0.2 million in foreign currency transactions and other related financial expenses, partially offset by a decrease in interest received on cash balances and marketable securities of $1.7 million, primarily attributable to the decline in interest rates in 2009.

Income tax expense. Income tax expense was $0.1 million in 2009 compared to an income tax expense of $0.2 million in 2008. The decrease is primarily attributable to a decrease in our tax provisions in the United States.

Year Ended December 31, 2008 Compared to Year Ended December 31, 2007

Revenues

Products. Product revenues increased by $2.0 million, or 8%, to $27.1 million in 2008 from $25.1 million in 2007. The increase is primarily attributable to successful deployment of our first product of the Service Gateway series.

Services. Service revenues increased by $2.6 million, or 35.1%, to $10 million in 2008 from $7.4 million in 2007. The increase in service revenues is primarily attributable to an increase in our installed base.

Revenues from products, which comprised 73.1% of our total revenues in 2008, decreased by 4% compared to 2007, while the service revenues increased by a similar percentage.

Cost of revenues and gross margin

Products. Cost of product revenues increased by $1.6 million, or 24.2%, to $8.2 million in 2008 from $6.6 million in 2007. This increase is consistent with the increase in revenues. Product gross margin was 69.7% in 2008 compared to 73.7% in 2007. This decrease is primarily attributable to higher sales volume of our high-end products, which require higher material and labor costs.

Services. Service cost of revenues increased by $0.1 million, or 7.1%, to $1.5 million in 2008 from $1.4 million in 2007. This increase is primarily attributable to increased royalties. Services gross margin was 85.0% in 2008 compared to 81.0% in 2007.

Total gross margin was 73.9% in 2008 compared to 75.3% in 2007.

Operating expenses

Research and development. Gross research and development expenses increased by $2.8 million, or 23.7%, to $14.6 million in 2008 from $11.8 million in 2007. This increase is primarily attributable to an increase in salaries and labor costs of approximately $1.3 million, which principally resulted from salary raises and the devaluation of the U.S. dollar relative to the shekel as well as the acquisition of the business of Esphion; an increase in other expenses, principally consisting of employee related expenses and overhead, of approximately $1.2 million; and an increase in depreciation of $0.3 million.

Research and development expenses, net of received and accrued grants from the Office of the Chief Scientist, increased by approximately $2.7 million, or 28%, to $12.0 million in 2008 from $9.3 million in 2007. Grants totaled $2.7 million in 2008 compared to $2.4 million in 2007. The increase in grants received is primarily attributable to the devaluation of U.S. dollar relative to the shekel. Research and development expenses, net, as a percentage of revenues increased to 32.2% in 2008 from 28.9% in 2007.

Sales and marketing. Sales and marketing expenses increased by $1.7 million in 2008, or 9.4%, to $19.8 million in 2008 from $18.1 million in 2007. This increase resulted from an increase in salaries and related expenses of $0.8 million, primarily related to an increase in presale support personnel, increased commissions resulting from increased sales, an increase of $0.6 million in travel expenses primarily due to increased sales and an increase of $0.3 million in depreciation.

Sales and marketing expenses, as a percentage of revenues decreased to 53.3% in 2008 from 55.6% in 2007.

General and administrative. General and administrative expenses increased by $0.6 million, or 10.7%, to $6.2 million in 2008 from $5.6 million in 2007. This increase is primarily attributable to an increase of $0.3 million in salaries and related expenses primarily due to devaluation of the U.S. dollar relative to the shekel, an increase in employee relate expenses and overhead expenses of $0.4 million and an increase in bad debt expenses of $0.1 million partially offset by a decrease in professional service and travel expenses of $0.2 million.

General and administrative expenses as a percentage of revenues decreased to 16.6% in 2008 from 17.2% in 2007.

Financial and other income (expenses), net. Financial and other income, net was $5.5 million in 2008 compared to $0.9 million in 2007. The increase in financial and other income, net is primarily attributable to a net impairment charge of $7.7 million compared to a net impairment charge of $4.9 million in 2007 related to our investment in ARS, a decrease in interest received on cash balances and marketable securities of $1.6 million, which is primarily attributable to the decline in interest rates in 2008, and an increase in interest and other expenses partially offset by a decrease in foreign currency transactions differences, net of $0.2 million.

Income tax expense. Income tax expense was $0.2 million in 2008 compared to an income tax expense of $0.5 million in 2007. The decrease is primarily attributable to a write-down of a withholding tax asset in 2007.

B. Liquidity and Capital Resources

From inception until consummation of our initial public offering we financed our operations primarily through private placements of our equity securities and, to a lesser extent, through borrowings from financial institutions. Sales of our equity securities including the consummation of our initial public offering resulted in net proceeds to us of approximately $112.7 million, net of issuance expenses.

As of December 31, 2009, we had $36.4 million in cash and cash equivalents, $2.3 million in restricted deposits and short term bank deposits and $14.5 million in marketable securities representing investments in ARS. As of December 31, 2009, our working capital, which we calculate by subtracting our current liabilities from our current assets, was $38.1 million.

Based on our current business plan, we believe that our existing cash balances, will be sufficient to meet our anticipated cash needs for working capital and capital expenditures for at least the next twelve months. In addition, we believe that the current lack of liquidity of the ARS will not have a material impact on our liquidity, cash flow or our ability to fund our operations for at least the next twelve months. If our estimates of revenues, expenses or capital or liquidity requirements change or are inaccurate and are insufficient to satisfy our liquidity requirements, we may seek to sell additional equity or arrange additional debt financing. In addition, we may seek to sell additional equity or arrange debt financing to give us financial flexibility to pursue attractive acquisition or investment opportunities that may arise in the future, although we currently do not have any specific acquisitions or investments planned.

Operating activities. Net cash used in operating activities in 2009 was $0.4 million. Net cash used in operating activities consisted of our net loss of $7.7 million, an increase of $0.7 million in inventories, an increase of $1.7 million in trade receivables, a $0.2 million increase in accrued severance pay net, an increase of $1.6 million in other receivables and a capital gain adjustment to our net loss of $0.1 million partially offset by non-cash expenses primarily attributable to a $3.0 million impairment charge against ARS, depreciation and amortization of fixed and intangible assets, including fixed assets write-off of $3.0 million and $2.3 million of stock-based compensation expense, and changes in balance sheet items that included a decrease of $0.3 million in long term deferred taxes, an increase of $0.7 million in deferred revenues and an increase of $2.3 million in trade and other payables.

Net cash used in operating activities in 2008 was $0.2 million. Net cash used in operating activities was primarily attributable to our net loss of $16.5 million and was partially offset by non-cash expenses consisting primarily of a $7.7 million impairment charge, net against ARS, $2.4 million of depreciation and amortization of intangible assets, including a write-down of in process research and development, $1.7 million of stock-based compensation expense. In addition, a decrease of $2.6 million in other receivables and prepaid expenses primarily attributable to collection of receivable from the Office of Chief Scientist, an increase of $1.4 million in deferred revenues and an increase of $1.0 million in other payables and accrued expenses, a decrease of $0.3 million in accrues severance pay and a decrease of $0.2 million in other assets offset by an increase of $0.5 million in trade payables and $0.4 million in employees and payroll accruals and an increase of $0.1 million in inventory.

Investing activities. Net cash used in investing activities in 2009 was $3.7 million, primarily attributable to purchasing of property and equipment of $3.6 million and $0.2 million increase in short-term bank deposits and restricted cash and deposits offset by $0.1 million proceeds from sale of property and equipment. Net cash provided by investing activities in 2008 was $12.0 million, primarily attributable to redemption and sale of available-for-sale marketable securities in the amount of $19.6 million, partially offset by $3.8 million attributable to the acquisition of Esphion, $1.7 million of capital investments related primarily to research and development equipment, and a $1.1 million increase in restricted deposit primarily for securing hedging transactions and $1.0 million investment in short term bank deposits.

We expect that our capital expenditures will total approximately $2.5 million in 2010. We anticipate that these capital expenditures will be primarily related to further investments in lab equipment for research and development, as well as customer support and demo units.

Financing activities. Net cash provided by financing activities in 2009 was $0.5 million, which was attributable to the issuance of share capital through stock options and exercises. Net cash provided by financing activities in 2008 was $0.1 million and was generated by the issuance of share capital through stock options and warrant exercises.

C. Research and Development, Patents and Licenses

Our research and development activities take place in Israel and New Zealand. As of December 31, 2009, 92 of our employees were engaged primarily in research and development. We devote a significant amount of our resources towards research and development to introduce and continuously enhance products to support our growth strategy.

Our research and development efforts have benefited from royalty-bearing grants from the Office of the Chief Scientist. For a description of restrictions on the transfer of the technology and with respect to manufacturing rights, see "ITEM 3: Key Information—Risk Factors—The government grants we have received for research and development expenditures restrict our ability to manufacture products and transfer technologies outside of Israel and require us to satisfy specified conditions. If we fail to comply with such restrictions or these conditions, we may be required to refund grants previously received together with interest and penalties, and may be subject to criminal charges."

Total research and development expenses, before royalty bearing grants, were approximately $11.8 million, $14.6 million and $11.7 million in the years ended December 31, 2007, 2008 and 2009, respectively. Royalty bearing grants amounted to$2.4 million, $2.7 million and $2.4 million in 2007, 2008 and 2009, respectively.

D. Trend Information

See "ITEM 5: Operating and Financial Review and Prospects" above.

E. Off Balance Sheet Arrangements

We are not a party to any material off-balance sheet arrangements. In addition, we have no unconsolidated special purpose financing or partnership entities that are likely to create material contingent obligations.

F. Contractual Obligations

The following table of our material contractual obligations known to us as of December 31, 2009, summarizes the aggregate effect that these obligations are expected to have on our cash flows in the periods indicated.

		Payments due by period			
Contractual Obligations	Total	Less than 1 year	1– 3 years	3-5 years	Over 5 years
	(in thousands of U.S. dollars)				
Operating leases — offices(1)	$3,447	$1,043	$1,705	$699	$-
Operating leases — vehicles	144	79	65	-	-
Purchase obligations	1.800	1,800	-	-	-
Accrued severance pay(2)	3,364	-	-	-	3,364
Other(3)	75	75	-	-	-
Total	$8.830	$2,997	$1,770	$699	$3,364

(1) Consists primarily of an operating lease for our facilities in Hod-Hasharon, Israel, as well as operating leases for facilities leased by our subsidiaries.
(2) Accrued severance pay relates to obligations to our Israeli employees as required under Israeli labor laws.
(3) Exposure associated with tax position for current year.

ITEM 6: Directors, Senior Management and Employees

A. Directors and Senior Management

Our directors and executive officers, their ages and positions as of April 1, 2010, are as follows:

Name	Age	Position
Directors		
Shraga Katz	57	Chairman of the Board
Rami Hadar	46	Director, Chief Executive Officer and President
Dr. Eyal Kishon(1)(2)	50	Director
Nurit Benjamini(1)(2)	43	Director
Shai Saul(1)	48	Director
Steven D. Levy(2)	53	Director
Yigal Jacoby	49	Director
Executive Officers		
Amir Hochbaum	50	Vice President — Research and Development
Anat Shenig	40	Vice President — Human Resources
Andrei Elefant	36	Vice President — Product Management and Marketing
Doron Arazi(3)	46	Chief Financial Officer
Eli Cohen	41	Vice President — International Sales
Jay Klein	46	Vice President — Chief Technology Officer
Lior Moyal	38	Vice President — Business Development
Pini Gvili	44	Vice President — Operations

Ramy Moriah	54	Vice President — Customer Care and Information Technology
Vin Costello	52	Vice President and General Manager — The Americas

(1) Member of our compensation and nomination committee.
(2) Member of our audit committee.
(3) Mr. Arazi will cease being our Chief Financial Officer following the filing of this annual report on Form 20-F.

Directors

Shraga Katz has served as the Chairman of our board of directors since 2008. Mr. Katz is a Venture Partner of Magma Venture Partners, a venture capital firm specializing in early-stage investments in communication, semiconductors, internet and media. Mr. Katz has over 30 years of experience in the technology sector and has specialized for over 20 years in the communications industry. In 1996, Mr. Katz founded Ceragon Networks Ltd. (NASDAQ: CRNT), a global provider of high capacity wireless networking solutions for mobile and fixed operators and private networks, and served as its President and CEO until mid 2005. Prior to founding Ceragon, Mr. Katz served in the Israeli Defense Forces for 17 years. Mr. Katz was head of the Electronic Research and Development Department of the Israeli Ministry of Defense. Mr. Katz is a two-time winner of the Israel Defense Award, Israel's most prestigious recognition for research and development. Mr. Katz holds a B.Sc. from the Technion — Israel Institute of Technology and an M.B.A. from Tel Aviv University.

Rami Hadar has served as our Chief Executive Officer and President since 2006 and is a member of our board of directors. Prior to joining us, Mr. Hadar founded CTP Systems, a developer of cordless telephony systems in 1989 and served as Chief Executive Officer until its acquisition by DSP Communications in 1995. Mr. Hadar continued with DSP Communication's executive management team for two years, and thereafter, in 1999, the company was acquired by Intel. In 1997, Mr. Hadar co-founded Ensemble Communications, a pioneer in the broadband wireless space and the WiMax standard, where he served as Executive Vice President of Sales and Marketing until 2002. Mr. Hadar also served as Chief Executive Officer of Native Networks from 2002 to 2005, which was successfully sold and integrated to Alcatel. Mr. Hadar holds a B.Sc. in Electrical Engineering from Technion — Israel Institute of Technology.

Dr. Eyal Kishon has served as a director since 1998. In 1996, Dr. Kishon co-founded Genesis Partners, an Israeli technology-driven venture capital fund, and currently serves as Founder and Managing Partner. From 1993 to 1996, Dr. Kishon served as the Associate Director of the Polaris Fund, now Pitango. Prior to that, Dr. Kishon served as Chief Technology Officer at Yozma Venture Capital from 1992 to 1993. From 1991 to 1992, he worked at the IBM Research Center, and from 1989 to 1991 he worked at the AT&T Bell Laboratories' Robotics Research Department. Dr. Kishon also serves as a director of AudioCodes Ltd. (NASDAQ: AUDC) and Celtro Inc. He holds a Ph.D. in Computer Science and Robotics from the Courant Institute of Mathematical Sciences at New York University and a B.A. in Computer Science from the Technion — Israel Institute of Technology. Dr. Kishon has written a number of scientific publications and holds a patent for signature verification for interactive security systems.

Nurit Benjamini has served as an outside director since 2007. Ms. Benjamini has served as the Chief Financial Officer of CopperGate Communications Ltd., a system-on-chip company that develops markets and sells chipsets for the home networking and MDU/MTU Broadband Access markets, since 2007. Previously, Ms. Benjamini served as the Chief Financial Officer of Compugen Ltd. (NASDAQ: CGEN) from 2000 to 2007. Prior to her position with Compugen Ltd., from 1998 to 2000, Ms. Benjamini served as the Chief Financial Officer of Phone-Or Ltd. Between 1993 and 1998, Ms. Benjamini served as the Chief Financial Officer of Aladdin Knowledge Systems Ltd.. Ms. Benjamini holds a B.A. in Economics and Business and an M.B.A. in Finance, both from Bar Ilan University, Israel.

Shai Saul has served as a director since 2000. Mr. Saul is currently Managing General Partner of Tamir Fishman Ventures. During 2001, he acted as interim-Chief Executive Officer of CopperGate Communications Ltd. From 1994 to 1999, Mr. Saul acted as Executive Vice President for Aladdin Knowledge Systems Ltd. (NASDAQ: ALDN, acquired by Vector in 2009), a leading provider of digital security solutions. From 1993 to 1994, he served as Chief Executive Officer of cleantech vendor Ganot Ltd., Mr. Saul also serves as Chairman of the Board of CopperGate Communications Ltd., and as member of the board of EZChip Semiconductor Ltd. (NASDAQ: EZCH), SuperFish Inc., Aniboom Ltd., Polls Boutique Ltd., Internet Fields Forever Ltd. and Tamir Fishman Ventures Management II Ltd. Mr. Saul holds an LL.B. from Tel Aviv University.

Steven D. Levy has served as an outside director since 2007. Mr. Levy served as a Managing Director and Global Head of Communications Technology Research at Lehman Brothers from 1998 to 2005. Before joining Lehman Brothers, Mr. Levy was a Director of Telecommunications Research at Salomon Brothers from 1997 to 1998, Managing Director and Head of the Communications Research Team at Oppenheimer & Co. from 1994 to 1997 and a senior communications analyst at Hambrecht & Quist from 1986 to 1994. Mr. Levy has served as a director of PCTEL, a broadband wireless technology company since January 2006. Mr. Levy holds a B.Sc. in Materials Engineering and an M.B.A., both from the Rensselaer Polytechnic Institute.

Yigal Jacoby co-founded our company in 1996 and serves as member of our board of directors. Mr. Jacoby was Chairman of our board of directors until 2008. Prior to co-founding Allot, Mr. Jacoby served as General Manager of Bay Network's Network Management Division in Santa Clara from 1996 to 1997. In 1992, he founded Armon Networking, a manufacturer of RMON-based network management solutions, which was sold to Bay Networks in 1996. He also held various engineering and marketing management positions at Tekelec, a manufacturer of Telecommunication monitoring and diagnostic equipment, including Director, OSI & LAN Products from 1989 to 1992 and Engineering Manager from 1987 to 1989. Mr. Jacoby has founded several startups in the communications field and served on their boards. Mr. Jacoby has a B.A., cum laude, in Computer Science from Technion — Israel Institute of Technology and an M.Sc. in Computer Science from University of Southern California.

Executive Officers

Amir Hochbaum has served as our Vice President — Research and Development since 2008. Before joining Allot, Mr. Hochbaum served as the Chief Operating Officer of Axerra Networks. From 2005 to 2007, Mr. Hochbaum was Senior Vice President, Research, Development and Operations of Vyyo Israel (NASDAQ: VYYO) where he also served as a member of Vyyo's executive management team. Prior to Vyyo, between 1994 and 2005, Mr. Hochbaum held a succession of management positions at Avaya (formerly Lucent, Madge and Lannet) including Managing Director and Vice President of R&D. Between 1984 and 1994, Mr. Hochbaum held a succession of management positions at ServiceSoft, including management of engineering, product development, product management and customer service . Mr. Hochbaum holds a B.S. in Mathematics and Computer Science and an M.S. in Computer Science from the Hebrew University of Jerusalem.

Anat Shenig joined our company in 2000 and has served as our Vice President — Human Resources since 2007. Ms. Shenig is responsible for human resources recruiting, welfare policy and employees' training. Prior to joining us, Ms. Shenig served as Human Resource Manager for Davidoff insurance company and as an organizational consultant for Aman Consulting. Ms. Shenig holds bachelor degrees in Psychology and Economics from Tel Aviv University and an M.B.A. in organizational behavior from Tel Aviv University.

Andrei Elefant joined our company in 2000 and has served as our VP Product Management since 2007. Mr. Elefant assumed responsibility to our marketing activities in 2008. Mr. Elefant is responsible for product management, product marketing and strategic project management. Prior to joining us, Mr. Elefant served as officer in the Israeli air force. Mr. Elefant holds a B.Sc. in Mechanical Engineering from the Technion — Israel Institute of Technology and an M.B.A. from Tel-Aviv University.

Doron Arazi has served as our Chief Financial Officer since 2007. Prior to joining us, Mr. Arazi held various financial positions at Verint Systems Ltd., one of the largest subsidiaries of Verint System Inc., an analytic software-based solutions provider. For the last three years, Mr. Arazi has served as Vice President Finance of Verint Systems Ltd. Mr. Arazi is a certified public accountant and he holds a B.A. in Accounting and Economics and an M.B.A. from Tel Aviv University.

Eli Cohen has served as our Vice President International Sales since 2008. Prior to joining us, from 2006 through 2008, Mr. Cohen was general manager of the Access Line business and before that the Vice President of Sales and Sales Operations for the Broadband Access Division at ECI Telecom, a supplier of networking infrastructure for carriers and service provider networks. Previously, Mr. Cohen held various senior positions in sales and marketing from 2002 to 2006 at ECI. Before that, between 1999 and 2002, Mr. Cohen was CEO and Director of Sales & Marketing of GigaSpaces Technologies, an e-commerce start-up company in the field of infrastructure for business and residential applications. Mr. Cohen has a B.Sc. in Electronic Engineering from Coventry University and an M.B.A. from Manchester University.

Jay Klein joined our company in 2006 and has served as our VP and CTO since 2007. Mr. Klein is responsible for driving our technology strategy, expanding our core algorithmic competence and driving intellectual property development, industry standards involvement and academic cooperation. Prior to joining us, between 2004 and 2006, Mr. Klein served as VP at DSPG (VoIP and multimedia silicon solutions) where he was responsible for strategic technology acquisitions. Between 1997 and 2003, Mr. Klein was Co-Founder and CTO of Ensemble Communications, a wireless access systems manufacturer and was one of the founders and creators of WiMAX and IEEE 802.16. Prior to that, between 1993 and 1997, he served as CTO and VP of R&D at CPT Systems, a cellular systems manufacturer, which was acquired by DSP Communications and later by Intel. Mr. Klein holds a B.Sc. in Electrical and Electronic Engineering from Tel-Aviv University.

Lior Moyal has served as VP Business Development since 2009. Mr. Moyal is responsible for driving the company's global business development strategy including developing partnerships with global system integrators, creating alliances with value added network and subscriber services partners, and recruiting and managing worldwide OEM partners. Prior to joining us, from 2008 to 2009, Mr. Moyal was VP of Business Development of AudioCodes (NasdaqGS: AUDC). Previously, from 2005 to 2007, Mr. Moyal was AudioCodes' VP of Marketing. Before that, from 2004 to 2005, Mr. Moyal was VP of Business Development at BridgeWave Communications. Prior to that, Mr. Moyal held variety of management positions in Orckit (Nasdaq: ORCT), including VP of Product Management and VP of Business Development. Mr. Moyal holds a B.Sc. in Physics from the Hebrew University of Jerusalem and an M.B.A. from Tel Aviv University.

Pini Gvili has served as our Vice President — Operations since 2006. Prior to joining us, from 2004 to 2006, he served as Vice President Operations for Celerica, a start-up company specializing in solutions for cellular network optimization. From 2001 to 2004, Mr. Gvili was the Vice President — Operations and IT at Terayon Communication Systems, and from 1998 to 2000, held the position of Manager of Integration and Final Testing at Telegate. Mr. Gvili was also a hardware/software engineer at Comverse/Efrat, a world leader of voice mail and digital recording systems, from 1994 to 1997. Mr. Gvili has a B.Sc. in Computer Science from Champlain University and was awarded a practical electronics degree from ORT Technical College.

Ramy Moriah has served as our Vice President — Customer Care & IT since 2005. Prior to joining us, Mr. Moriah was a founding member of Daisy System's Design Center in Israel, in 1984. From 1991 to 1994, Mr. Moriah held the position of Manager of Software Development at Orbot Instruments, a world leader of Automatic Optical Inspection manufacturer for the VLSI Chip Industry. Mr. Moriah was also the acting General Manager at ACA, 3D CAD/solid modeling software for architecture from 1995 to 1997, and served there as Vice President — Research and Development from 1995 to 1997. Mr. Moriah holds a B.Sc., cum laude , in Computer Engineering from the Technion — Israel Institute of Technology and an M.Sc. in Management and Information Systems from the Tel Aviv University School of Business Administration.

Vin Costello has served as our VP and & General Manager – Americas since 2006. Mr. Costello began his career with NYNEX and rapidly rose through the ranks achieving the title of Vice President, Business Network Solutions and Vice President Global Sales. Mr. Costello founded and headed NYNEX Network Integration and upon the merger with Bell Atlantic, was named President and CEO of Bell Atlantic Network Integration. Mr. Costello departed Verizon for an optical networking start-up where he served as VP of Sales and assisted Corvis Corporation, in their successful initial public offering. Mr. Costello was subsequently named VP and General Manager of the Managed Storage Division after Corvis purchased Broadwing and reinvented itself as a service provider. Mr. Costello holds a B.Sc. in Computer Applications and Information Systems as well as Business Management (double major) from New York University and earned an M.Sc. in Telecommunications and Computing Management from Polytechnic University.

B. Compensation of Officers and Directors

The aggregate compensation paid to or accrued on behalf of our directors and executive officers as a group during 2009 consisted of approximately $2.0 million in salary, fees, bonus, commissions and directors' fees and approximately $95,000 in amounts set aside or accrued to provide pension, retirement or similar benefits, but excluding amounts we expended for automobiles made available to our officers, expenses, including dues for professional and business associations, business travel and other expenses, and other benefits commonly reimbursed or paid by companies in Israel.

We pay each of our outside directors an annual fee of $10,000, paid in four equal installments of $2,500, at the beginning of each calendar quarter with respect to the preceding quarter (with a pro-rata payment for the first and last calendar quarters of service, to the extent the outside director did not serve as such during the entire calendar quarter). Each outside director also was granted upon his or her election and reelection options to purchase 15,000 of our ordinary shares, which vest on a quarterly basis over a period of three years.

During 2009, our officers and directors received, in the aggregate, options to purchase 372,748 ordinary shares under our equity based compensation plans, of which 157,748 options were granted as part of stock option trade-in program in exchange for the participants' agreement to cancel underwater options that were previously granted to them. These options have a weighted average exercise price of approximately $3.52 and the options will expire ten years after the date the options were granted.

C. Board Practices

Corporate Governance Practices

As a foreign private issuer, we are permitted under NASDAQ Marketplace Rule 5615(a)(3) to follow Israeli corporate governance practices instead of the NASDAQ Stock Market requirements, provided we disclose which requirements we are not following and the equivalent Israeli requirement. See "ITEM 16F: Corporate Governance Requirements" for a discussion of those ways in which our corporate governance practices differ from those required by NASDAQ for domestic companies.

Board of Directors

Terms of Directors

Our articles of association provide that we may have not less than five directors and up to nine directors.

Under our articles of association our directors (other than the outside directors, whose appointment is required under the Companies Law; see "—Outside Directors") are divided into three classes. Each class of directors consists, as nearly as possible, of one-third of the total number of directors constituting the entire board of directors (other than the outside directors). At each annual general meeting of our shareholders, the election or re-election of directors following the expiration of the term of office of the directors of that class of directors, will be for a term of office that expires on the third annual general meeting following such election or re-election, such that each year the term of office of only one class of directors will expire. Shraga Katz who is a Class I director, will hold office until our annual meeting of shareholders to be held in 2010. Class II directors, consisting of Dr. Eyal Kishon and Shai Saul, will hold office until our annual meeting of shareholders to be held in 2011. Class III directors, consisting of Yigal Jacoby and Rami Hadar, will hold office until our annual meeting of shareholders to be held in 2012. The directors shall be elected by a vote of the holders of a majority of the voting power present and voting at that meeting. Each director, will hold office until the annual general meeting of our shareholders for the year in which his term expires and until his successor is elected and qualified, unless the tenure of such director expires earlier pursuant to the Companies Law or unless he resigns or is removed from office as described below.

Under the Israeli Companies Law, a director (including an outside director) may be appointed to serve in a public company only if he or she has declared in writing that he or she has the required skills and the ability to dedicate the time required to serve as a director, in view of such company's requirements and scale and during the past five years he or she was not convicted in a final and non-appealable judgment of certain criminal and securities law offenses. Additionally, a director (including an outside director) may be appointed only provided that he or she is not restricted by any court or executive authority from serving as a director, was never declared incompetent by a court, and was either never declared bankrupt or was declared bankrupt but was later discharged by the court. A director that ceases to meet the statutory requirements for his or her appointment must immediately notify us of the same and his or her office will become vacated upon such notice.

Under our articles of association the approval of a special majority of the holders of at least 75.0% of the voting rights present and voting at a general meeting is generally required to remove any of our directors (other than the outside directors) from office. The holders of a majority of the voting power present and voting at a meeting may elect directors in their stead or fill any vacancy, however created, in our board of directors. In addition, vacancies on our board of directors, other than vacancies created by an outside director, may be filled by a vote of a simple majority of the directors then in office. A director so chosen or appointed will hold office until the next annual general meeting of our shareholders, unless earlier removed by the vote of a majority of the directors then in office prior to such annual meeting. See “—Outside Directors” for a description of the procedure for election of outside directors.

Outside Directors

Qualifications of Outside Directors

Under the Israeli Companies Law, companies incorporated under the laws of the State of Israel that are “public companies,” which also includes companies with shares listed on the NASDAQ Stock Market, are required to appoint at least two outside directors. Our outside directors are Ms. Benjamini and Mr. Levy.

A person may not serve as an outside director if at the date of the person’s appointment or within the prior two years, the person, the person’s relatives, entities under the person’s control, any person or entity to whom such person is subordinated (whether directly or indirectly) or the person’s partners or employer, have or had any affiliation with us or any entity controlled by or under common control with us during the prior two years, or which controls us at the time of such person’s appointment.

The term affiliation includes:

Ÿ an employment relationship;

Ÿ a business or professional relationship maintained on a regular basis;

Ÿ control; and

Ÿ service as an office holder, excluding service as a director in a private company prior to the first offering of its shares to the public if such director was appointed as a director of the private company in order to serve as an outside director following the public offering.

The term relative is defined as spouses, siblings, parents, grandparents, descendants, spouse’s descendants and the spouses of each of these persons.

The term office holder is defined as a director, general manager, chief business manager, deputy general manager, vice general manager, executive vice president, vice president, other manager directly subordinate to the general manager or any other person assuming the responsibilities of any of the foregoing positions, without regard to such person's title. Each person listed under "—Directors and Senior Management" is an office holder.

No person can serve as an outside director if the person's position or other business create, or may create, a conflict of interests with the person's responsibilities as a director or may otherwise interfere with the person's ability to serve as a director. If at the time an outside director is appointed all current members of the board of directors are of the same gender, then that outside director must be of the other gender.

The Companies Law provides that each outside director must meet certain professional qualifications or have financial and accounting expertise, and that at least one outside director must have financial and accounting expertise. However, if at least one of our directors meets the independence requirements of the Securities Exchange Act of 1934, as amended, and the standards of the NASDAQ Stock Market rules for membership on the audit committee and also has financial and accounting expertise as defined in the Companies Law and applicable regulations, then our outside directors are required to meet the professional qualifications only. Under applicable regulations, a director with financial and accounting expertise is a director who, by reason of his or her education, professional experience and skill, has a high level of proficiency in and understanding of business accounting matters and financial statements. He or she must be able to thoroughly comprehend the financial statements of the company and initiate debate regarding the manner in which financial information is presented. The regulations define a director with the requisite professional qualifications as a director who satisfies one of the following requirements: (1) the director holds an academic degree in either economics, business administration, accounting, law or public administration, (2) the director either holds an academic degree in any other field or has completed another form of higher education in the company's primary field of business or in an area which is relevant to the office of an outside director, or (3) the director has at least five years of cumulative experience serving in one or more of the following capacities: (a) a senior business management position in a corporation with a substantial scope of business, (b) a senior position in the company's primary field of business or (c) a senior position in public administration. An outside director that ceases to meet the statutory requirements for his or her appointment must immediately notify us of the same and his or her office will become vacated upon such notice.

Until the lapse of two years from termination of office, a company may not engage an outside director to serve as an office holder and cannot employ or receive professional services for payment from that person, either directly or indirectly, including through a corporation controlled by that person.

Election of Outside Directors

Outside directors are elected by a majority vote at a shareholders' meeting, provided that either:

- Ÿthe majority of shares voted at the meeting, including at least one-third of the shares of non-controlling shareholders voted at the meeting, excluding abstentions, vote in favor of the election of the outside director; or

- the total number of shares of non-controlling shareholders voted against the election of the outside director does not exceed one percent of the aggregate voting rights in the company.

The initial term of an outside director is three years and he or she may be reelected to additional terms of three years each by a majority vote at a shareholders' meeting, subject to the conditions described above for election of outside directors. Reelection to each additional term beyond the first extension must comply with the following additional conditions: (1) the audit committee and, subsequently, the board of directors confirmed that the reelection for an additional term is for the benefit of the company, taking into account the outside director's expertise and special contribution to the function of the board of directors and its committees, and (2) the general meeting of the company's shareholders, prior to its approval of the reelection of the outside director, was informed of the term previously served by him or her and of the reasons of the board of directors and audit committee for the extension of the outside director's term. Outside directors may only be removed by the same majority of shareholders as is required for their election, or by a court, as follows: (1) if the board of directors is made aware of a concern that an outside director has ceased to meet the statutory requirements for his or her appointment, or has violated his or her duty of loyalty to the company, then the board of directors is required to discuss the concern and determine whether it is justified, and if the board of directors determines that the concern is justified, to call a special general meeting of the company's shareholders, the agenda of which includes the dismissal of the outside director; and (2) at the request of a director or a shareholder of the company, a court may remove an outside director from office if it determines that the outside director has ceased to meet the statutory requirements for his or her appointment, or has violated his or her duty of loyalty to the company, or (3) at the request of the company, a director, a shareholder or a creditor of the company, a court may remove an outside director from office if it determines that the outside director is unable to perform his or her duties on a regular basis, or is convicted of certain offenses set forth in the Companies Law. In addition, an outside director that ceases to meet the statutory requirements for his or her appointment must immediately notify us of the same and his or her office will become vacated upon such notice. If the vacancy of an outside directorship causes the company to have fewer than two outside directors, a company's board of directors is required under the Companies Law to call a special general meeting of the company's shareholders as soon as possible to appoint a new outside director. Each committee of a company's board of directors which is authorized to exercise the board of directors' authorities is required to include at least one outside director, except for the audit committee, which is required to include all outside director.

An outside director is entitled to compensation as provided in regulations promulgated under the Companies Law and is otherwise prohibited from receiving any other compensation, directly or indirectly, in connection with services provided as an outside director.

NASDAQ Requirements

Under the rules of the NASDAQ Stock Market, a majority of directors must meet the definition of independence contained in those rules. Our board of directors has determined that all of our directors, other than Shraga Katz, Yigal Jacoby and Rami Hadar, meet the independence standards contained in the rules of the NASDAQ Stock Market. We do not believe that any of these directors have a relationship that would preclude a finding of independence under these rules and, in reaching its determination, our board of directors determined that the other relationships that these directors have with us do not impair their independence.

Audit Committee

Companies Law Requirements

Under the Companies Law, the board of directors of any public company must also appoint an audit committee comprised of at least three directors including all of the outside directors, but excluding the:

- Ÿ chairman of the board of directors;
- Ÿ controlling shareholder or a relative of a controlling shareholder; and
- Ÿ any director employed by the company or who provides services to the company on a regular basis.

NASDAQ Requirements

Under the NASDAQ Stock Market rules, we are required to maintain an audit committee consisting of at least three independent directors, all of whom are financially literate and one of whom has accounting or related financial management expertise. Our audit committee members are required to meet additional independence standards, including minimum standards set forth in rules of the Securities and Exchange Commission and adopted by the NASDAQ Stock Market.

Approval of Transactions with Office Holders and Controlling Shareholders

The approval of the audit committee is required to effect specified actions and transactions with office holders and controlling shareholders. The term controlling shareholder means a shareholder with the ability to direct the activities of the company, other than by virtue of being an office holder. A shareholder is presumed to be a controlling shareholder if the shareholder holds 50.0% or more of the voting rights in a company or has the right to appoint the majority of the directors of the company or its general manager. For the purpose of approving transactions with controlling shareholders, the term also includes any shareholder that holds 25.0% or more of the voting rights of the company if the company has no shareholder that owns more than 50.0% of its voting rights. For purposes of determining the holding percentage stated above, two or more shareholders who have a personal interest in a transaction that is brought for the company's approval are deemed as joint holders. The audit committee may not approve an action or a transaction with a controlling shareholder or with an office holder unless at the time of approval two outside directors are serving as members of the audit committee and at least one of them was present at the meeting at which the approval was granted.

Audit Committee Role

Our board of directors has adopted an audit committee charter setting forth the responsibilities of the audit committee consistent with the rules of the Securities and Exchange Commission and the NASDAQ Global Market rules, which include:

Ÿ retaining and terminating the company's independent auditors, subject to shareholder ratification;

Ÿ pre-approval of audit and non-audit services provided by the independent auditors; and

Ÿ approval of transactions with office holders and controlling shareholders, as described above, and other related-party transactions.

Additionally, under the Companies Law, the role of the audit committee is to identify irregularities in the business management of the company in consultation with the internal auditor or the company's independent auditors and suggest an appropriate course of action to the board of directors, to approve related-party actions and transactions per the instructions of the Companies Law and to approve the yearly or periodic work plan proposed by the internal auditor to the extent required. The audit committee charter states that in fulfilling this role the committee is entitled to rely on interviews and consultations with our management, our internal auditor and our independent auditor, and is not obligated to conduct any independent investigation or verification.

Our audit committee consists of our directors, Ms. Nurit Benjamini, Mr. Steven Levy and Dr. Eyal Kishon. The financial expert on the audit committee pursuant to the definition of the Securities and Exchange Commission is Ms. Benjamini.

Compensation and Nominating Committee

We have established a compensation and nominating committee consisting of our directors, Dr. Eyal Kishon, Ms. Nurit Benjamini and Mr. Shai Saul. This committee also oversees matters related to our corporate governance practices. Our board of directors has adopted a compensation and nominating committee charter setting forth the responsibilities of the committee consistent with the NASDAQ Stock Market rules, which include:

Ÿ determining the compensation of our Chief Executive Officer and other executive officers;

Ÿ granting options to our employees and the employees of our subsidiaries;

Ÿ recommending candidates for nomination as members of our board of directors; and

Ÿ developing and recommending to the board corporate governance guidelines and a code of business ethics and conduct in accordance with applicable laws.

Internal Auditor

Under the Companies Law, the board of directors of a public company must appoint an internal auditor nominated by the audit committee. The role of the internal auditor is, among other things, to examine whether a company's actions comply with applicable law and orderly business procedure. Under the Companies Law, the internal auditor may be an employee of the company but not an interested party or an office holder or a relative of an interested party or an office holder, nor may the internal auditor be the company's independent auditor or the representative of the same. An interested party is defined in the Companies Law as a holder of 5.0% or more of the issued share capital or voting power in a company, any person or entity who has the right to designate one director or more or the chief executive officer of the company or any person who serves as a director or as a chief executive officer. In February 2007, our board of directors approved the appointment of the firm of Haikin, Rubin, Cohen & Gilboa as the internal auditor of the Company.

Exculpation, Insurance and Indemnification of Office Holders

Under the Companies Law, a company may not exculpate an office holder from liability for a breach of the duty of loyalty. However, a company may approve an act performed in breach of the duty of loyalty of an office holder provided that the office holder acted in good faith, the act or its approval does not harm the company, and the office holder discloses the nature of his or her personal interest in the act and all material facts and documents a reasonable time before discussion of the approval. An Israeli company may exculpate an office holder in advance from liability to the company, in whole or in part, for damages caused to the company as a result of a breach of duty of care but only if a provision authorizing such exculpation is inserted in its articles of association. Our articles of association include such a provision. An Israeli company may not exculpate a director for liability arising out of a prohibited dividend or distribution to shareholders.

An Israeli company may indemnify an office holder in respect of certain liabilities either in advance of an event or following an event provided a provision authorizing such indemnification is inserted in its articles of association. Our articles of association contain such an authorization. An undertaking provided in advance by an Israeli company to indemnify an office holder with respect to a financial liability imposed on him or her in favor of another person pursuant to a judgment, settlement or arbitrator’s award approved by a court must be limited to events which in the opinion of the board of directors can be foreseen based on the company’s activities when the undertaking to indemnify is given, and to an amount or according to criteria determined by the board of directors as reasonable under the circumstances, and such undertaking shall detail the above mentioned events and amount or criteria. In addition, a company may undertake in advance to indemnify an office holder against the following liabilities incurred for acts performed as an office holder:

- reasonable litigation expenses, including attorneys’ fees, incurred by the office holder as a result of an investigation or proceeding instituted against him or her by an authority authorized to conduct such investigation or proceeding, provided that (i) no indictment was filed against such office holder as a result of such investigation or proceeding; and (ii) no financial liability, such as a criminal penalty, was imposed upon him or her as a substitute for the criminal proceeding as a result of such investigation or proceeding or, if such financial liability was imposed, it was imposed with respect to an offense that does not require proof of criminal intent; and

- reasonable litigation expenses, including attorneys’ fees, incurred by the office holder or imposed by a court in proceedings instituted against him or her by the company, on its behalf or by a third party or in connection with criminal proceedings in which the office holder was acquitted or as a result of a conviction for an offense that does not require proof of criminal intent.

An Israeli company may insure an office holder against the following liabilities incurred for acts performed as an office holder if and to the extent provided in the company's articles of association:

- Ÿ breach of duty of loyalty to the company, to the extent that the office holder acted in good faith and had a reasonable basis to believe that the act would not prejudice the company;

- Ÿ breach of duty of care to the company or to a third party, including a breach arising out of the negligent conduct of the office holder; and

- Ÿ a financial liability imposed on the office holder in favor of a third party.

An Israeli company may not indemnify or insure an office holder against any of the following:

- Ÿ breach of duty of loyalty, except to the extent that the office holder acted in good faith and had a reasonable basis to believe that the act would not prejudice the company;

- Ÿ breach of duty of care committed intentionally or recklessly, excluding a breach arising out of the negligent conduct of the office holder;

- Ÿ an act or omission committed with intent to derive illegal personal benefit; or

- Ÿ a fine or forfeit levied against the office holder.

Under the Companies Law, exculpation, indemnification and insurance of office holders must be approved by our audit committee and our board of directors and, in respect of our directors, by our shareholders.

Our articles of association allow us to indemnify and insure our office holders to the fullest extent permitted by the Companies Law. Our office holders are currently covered by a directors and officers' liability insurance policy. In May 2007, we and certain of our officers and directors were named as defendants in a number of purported securities class action lawsuits filed in the United States District Court for the Southern District of New York and that were consolidated to "In re Allot Communications Ltd. Securities Litigation." under Master File No. 07-cv-03455 (RJH). See "ITEM 8: Financial Information—Consolidated Statements and Other Financial Information—Legal Proceedings." As of the date of this annual report, no other claims for directors and officers' liability insurance have been filed under our policies and we are not aware of any pending or threatened litigation or proceeding involving any of our directors or officers in which indemnification is sought.

We have entered into agreements with each of our directors and with certain of our office holders exculpating them, to the fullest extent permitted by law, from liability to us for damages caused to us as a result of a breach of duty of care, and undertaking to indemnify them to the fullest extent permitted by law. This indemnification is limited to events determined as foreseeable by the board of directors based on our activities, and to an amount or according to criteria determined by the board of directors as reasonable under the circumstances, and the insurance is subject to our discretion depending on its availability, effectiveness and cost. The current maximum amount set forth in such agreements is the greater of (1) with respect to indemnification in connection with a public offering of our securities, the gross proceeds raised by us and/or any selling shareholder in such public offering, and (2) with respect to all permitted indemnification, including a public offering of our securities, an amount equal to 50% of the our shareholders' equity on a consolidated basis, based on our most recent financial statements made publicly available before the date on which the indemnity payment is made.

In the opinion of the U.S. Securities and Exchange Commission, however, indemnification of directors and office holders for liabilities arising under the Securities Act is against public policy and therefore unenforceable.

D. Employees

As of December 31, 2009, we had 252 employees of whom 170 were based in Israel, 29 in the United States and the remainder in Asia and Europe. The breakdown of our employees by department is as follows:

	December 31,		
Department	2007	2008	2009
Manufacturing and operations	16	16	16
Research and development	92		