

RADCOM LTD
Form 20-F
March 30, 2006

**UNITED STATES
SECURITIES AND EXCHANGE COMMISSION**

Washington, D.C. 20549

FORM 20-F

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

OR

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

For the fiscal year ended December 31, 2005

OR

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

For the transition period from _____ to _____

OR

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

Date of event requiring this shell company report _____

Commission file number **0-29452**

RADCOM Ltd.

(Exact name of Registrant as specified in its charter)

Israel

(Jurisdiction of incorporation or organization)

24 Raoul Wallenberg Street, Tel Aviv 69719, Israel

(Address of principal executive offices)

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

Title of each class

**Name of each exchange on which
registered**

None

None

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

Ordinary Shares, NIS 0.05 par value per share
(Title of Class)

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

None
(Title of Class)

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

14,958,477 Ordinary Shares, NIS 0.05 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 No

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

Yes No

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

Yes No

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

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

Item 17 Item 18

Large Accelerated Filer Accelerated Filer Non-Accelerated Filer

If this is an annual report, indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes No

INTRODUCTION

RADCOM Ltd. develops, manufactures, markets and supports innovative, high-performance internetworking test and analysis equipment and quality management for data communications and telecommunications networks. We were incorporated in 1985 under the laws of the State of Israel and commenced operations in 1991.

Except for the historical information contained herein, the statements contained in this annual report are forward-looking statements, within the meaning of the Private Securities Litigation Reform Act of 1995, with respect to our business, financial condition and results of operations. Actual results could differ materially from those anticipated in these forward-looking statements as a result of various factors, including all the risks discussed in “Item 3-Key Information-Risk Factors” and elsewhere in this annual report.

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

As used in this annual report, the terms “we,” “us,” “our,” and “RADCOM” mean RADCOM Ltd. and its subsidiaries, unless otherwise indicated.

PrismLite™, Omni-Q™, MediaPro™ and Wirespeed™ are our trademarks. All other trademarks and trade names appearing in this annual report are owned by their respective holders.

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PART I

ITEM 1. IDENTITY OF DIRECTORS, SENIOR MANAGEMENT AND ADVISORS

Not applicable.

ITEM 2. OFFER STATISTICS AND EXPECTED TIMETABLE

Not applicable.

ITEM 3. KEY INFORMATION

A. SELECTED FINANCIAL DATA

We have derived the following selected consolidated financial data as of December 31, 2004 and 2005 and for each of the years ended December 31, 2003, 2004, and 2005 from our consolidated financial statements and notes included in this annual report. The selected consolidated financial data as of December 31, 2001, 2002 and 2003 and for the years ended December 31, 2001 and 2002 have been derived from audited consolidated financial statements not included in this annual report.

You should read the selected consolidated financial data together with “Item 5—Operating and Financial Review and Prospects” and our consolidated financial statements included elsewhere in this annual report.

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Year Ended December 31,
In Thousands of U.S. dollars (except weighted average number of ordinary shares,
basic and diluted loss per ordinary share)

	2001	2002	2003	2004	2005
Statement of Operations Data:					
Sales	18,676	14,591	11,203	16,055	22,340
Cost of sales	8,811	5,047	4,894	5,127	7,398
Gross profit	9,865	9,544	6,309	10,928	14,942
Operating expenses:					
Research and development	9,380	6,481	5,593	5,232	5,815
Less - royalty - bearing participation	1,976	2,328	1,997	1,722	1,735
Research and development, net	7,404	4,153	3,596	3,510	4,080
Sales and marketing	11,513	8,306	7,411	6,983	7,881
General and administrative	2,437	2,018	1,620	2,191	1,689
Total operating expenses	21,354	14,477	12,627	12,684	13,650
Operating income (loss)	(11,489)	(4,933)	(6,318)	(1,756)	1,292
Financing income, net	41	217	93	78	235
Net income (loss) for the year	(11,448)	(4,716)	(6,225)	(1,678)	1,527
Basic net income (loss) per ordinary share	\$ (1.09)	\$ (0.45)	\$ (0.59)	\$ (0.12)	\$ 0.10
Weighted average number of ordinary shares used to compute basic net income (loss) per ordinary share	10,511,789	10,492,050	10,493,184	13,453,509	14,696,090
Diluted net income (loss) per ordinary share	\$ (1.09)	\$ (0.45)	\$ (0.59)	\$ (0.12)	\$ 0.10
Weighted average number of ordinary shares used to compute diluted net income (loss) per ordinary share	10,511,789	10,492,050	10,493,184	13,453,509	15,561,585
Balance Sheet Data:					
Working capital	14,444	10,707	5,702	10,051	12,987
Total assets	24,306	19,429	14,403	20,129	23,790
Shareholders' equity	16,926	12,344	6,246	10,024	12,485

B. CAPITALIZATION AND INDEBTEDNESS

Not applicable.

C. REASONS FOR THE OFFER AND USE OF PROCEEDS

Not applicable.

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D. RISK FACTORS

Our business, operating results and financial condition could be seriously harmed due to any of the following risks, among others. If we do not successfully address the risks to which we are subject, we could experience a material adverse effect on our business, results of operations and financial condition and our share price may decline. We cannot assure you that we will successfully address any of these risks.

Risks Related to our Business and our Industry

We may incur losses in the future.

Although we had net income in the fiscal year ended December 31, 2005, in the fiscal years ended December 31, 2003 and 2004, we incurred losses. We may incur losses in the future, which could materially affect our cash and adversely affect the value and market price of our shares.

From time to time we may need to raise financing. If adequate funds are not available on terms favorable to us or to our shareholders, our operations and growth strategy will be materially adversely affected.

Although we recorded a net profit and were cash positive in 2005, from time to time we may be required to raise financing in connection with our operations and growth strategy. We do not know whether additional financing will be available when needed, or whether it will be available on terms favorable to us. If adequate funds are not available on terms favorable to us or to our shareholders, our operations and growth strategy will be materially adversely affected. For example, as a result of the net losses during the year ended December 31, 2004, we used approximately \$2.2 million in cash during that period.

We might not satisfy all the requirements for continued listing on the NASDAQ National Market, and our shares may be delisted.

We are currently in compliance with all requirements for continued listing on the NASDAQ National Market. We cannot assure you, however, that we will maintain such compliance over the long term or that we will be able to maintain compliance with all of the continued listing requirements for the NASDAQ National Market. If we fail to comply with any of the continued listing requirements, we could be delisted from the NASDAQ National Market. Our shares would then be quoted on the NASDAQ Small Cap Market (if we satisfy the continued listing requirements for that market) or the Over-The-Counter Bulletin Board. For example, from time to time during 2003, our share price decreased below the required minimum bid price, and we did not maintain the required minimum market value of publicly held shares. In addition, in 2003, we fell below the minimum \$10 million shareholders' equity requirement. In March 2004, we raised \$5.5 million in a private placement of 3,851,540 of our ordinary shares and warrants to purchase 962,887 of our ordinary shares. This equity financing enabled us, among other things, to sustain near-term compliance with certain continued listing requirements of the NASDAQ National Market. Depending upon our level of revenues in the future and the strategy we adopt, we may need to raise additional debt or equity capital to meet our working capital needs in the future.

We have a history of quarterly fluctuations and unpredictability in our results of operations and expect these fluctuations to continue. This may cause our stock price to decline.

We have experienced and expect to experience in the future significant fluctuations in our quarterly results of operations. Factors that may contribute to fluctuations in our quarterly results of operations include:

- the variation in size and timing of individual purchases by our customers;

- absence of long-term customer purchase contracts;

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- seasonal factors that may affect capital spending by customers, such as the varying fiscal year-ends of customers and the reduction in business during the summer months, particularly in Europe;
 - the relatively long sales cycles for our products;
 - competitive conditions in our markets;
- the timing of the introduction and market acceptance of new products or product enhancements by us and by our customers, competitors and suppliers;
 - changes in the level of operating expenses relative to revenues;
 - product quality problems;
 - supply interruptions;
 - changes in global or regional economic conditions or in the telecommunications industry;
 - delays in purchasing decisions or customer orders due to customer consolidation;
 - changes in the mix of products sold; and
 - size and timing of approval of grants from the Government of Israel.

We believe, therefore, that period-to-period comparisons of our operating results should not be relied upon as an indication of future performance.

Our revenues in any period generally have been, and may continue to be, derived from a relatively small number of orders with relatively high average revenues per order. Therefore, the loss of any order or a delay in closing a transaction could have a more significant impact on our quarterly revenues and results of operations than on those of companies with relatively high volumes of sales or low revenues per order. Our products generally are shipped within 15 to 30 days after orders are received. As a result, we generally do not have a significant backlog of orders, and revenues in any quarter are substantially dependent on orders booked, shipped and installed in that quarter.

We may experience a delay in generating or recognizing revenues for a number of reasons. Unfulfilled orders at the beginning of each quarter are typically substantially less than our expected revenues for that quarter. Therefore, we depend on obtaining orders in a quarter for shipment in that quarter to achieve our revenue objectives. Moreover, demand for our products may fluctuate as a result of seasonality.

Our revenues for a particular period may also be difficult to predict and may be adversely affected if we experience a non-linear (back-end loaded) sales pattern during the period. We sometimes experience significantly higher levels of sales towards the end of a period as a result of customers submitting their orders late in the period or as a result of manufacturing issues or component shortages which may delay shipments. Such non-linearity in shipments can increase costs, as irregular shipment patterns result in periods of underutilized capacity and periods when overtime expenses may be incurred, as well as leading to additional costs associated with inventory planning and management. Furthermore, orders received towards the end of the period may not ship within the period due to our manufacturing lead times

Most of our costs, including personnel and facilities costs, are relatively fixed at levels based on anticipated revenue. As a result, a decline in revenue from even a limited number of orders could result in our failure to achieve expected

revenue in any quarter and unanticipated variations in the timing of realization of revenue could cause significant variations in our quarterly operating results and could result in losses.

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If our revenues in any quarter remain level or decline in comparison to any prior quarter, our financial results could be materially adversely affected. In addition, if we do not reduce our expenses in a timely manner in response to level or declining revenues, our financial results for that quarter could be materially adversely affected.

Due to the factors described above, as well as other unanticipated factors, in future quarters our results of operations could fail to meet the expectations of public market analysts or investors. If this occurs, the price of our common stock may fall.

A slowdown in the telecommunications industry could materially adversely affect our revenues and results of operations.

Our future success is dependent upon the continued growth of the telecommunications industry. The global telecommunications industry is evolving rapidly, and it is difficult to predict its potential growth rate or future trends in technology development. The deregulation, privatization and economic globalization of the worldwide telecommunications market that have resulted in increased competition and escalating demand for new technologies and services may not continue in a manner favorable to us or our business strategies. In addition, the growth in demand for Internet services and the resulting need for high speed or enhanced telecommunications equipment may not continue at its current rate or at all.

Our future success depends upon the increased utilization of our test solutions by network operators and telecommunications equipment vendors. Industry-wide network equipment and infrastructure development driving the demand for our products and services may be delayed or prevented by a variety of factors, including cost, regulatory obstacles or the lack of or reduction in consumer demand for advanced telecommunications products and services. Telecommunications equipment vendors and network operators may not develop new technology or enhance current technology. Further, any such new technology or enhancements may not lead to greater demand for our products.

Continued negative trends and factors affecting the telecommunications industry specifically and the economy in general may result in reduced demand and pricing pressure on our products.

Negative trends and factors affecting the telecommunications industry specifically and the economy in general over the past several years have negatively affected our results of operations. As a result of the build-up of capacity by telecommunications companies in the late 1990s, the telecommunications sector has been facing significant challenges from excess capacity, new technologies and intense price competition. This excess network capacity, combined with the failure of many competitors in the telecommunications sector, has contributed to delayed adoption of next-generation cellular and wireline networks. As a result, we experienced a significant decline in demand for our products in 2001, 2002, and the first half of 2003, resulting in a significant decline in sales and revenues. In addition, weak economic conditions in the last recession resulted in reduced capital expenditures, reluctance to commit to long-term capital outlays and longer sales processes for network procurements by our customers. Although this trend has abated, we cannot predict the duration of the improvement or the impact it may have on our results of operations. Finally, an overall trend toward industry consolidation and rationalization among our customers, competitors and suppliers can affect our business, especially if any of the sectors we service or the countries or regions that we do business in are affected. Any future weakness in the economy or the telecommunications industry could affect us through reduced demand for our products, leading to a reduction in revenues and a material adverse effect on our business and results of operations.

The market for our products is characterized by changing technology, requirements, standards and products, and we may be materially adversely affected if we do not respond promptly and effectively to such changes.

The telecommunications market for our products is characterized by rapidly changing technology, changing customer requirements, evolving industry standards and frequent new product introductions, certain of which changes could reduce the market for our products or require us to develop new products. For example, the sharp reduction in demand

for our ATM and frame relay products during 2003 resulted in significantly reduced revenues for the year.

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New or enhanced telecommunications and data communications-related products developed by other companies could be incompatible with our products. Therefore, our timely access to information concerning, and our ability to anticipate, changes in technology and customer requirements and the emergence of new industry standards, as well as our ability to develop, manufacture and market new and enhanced products successfully and on a timely basis, will be significant factors in our ability to remain competitive. For example, many of our strategic initiatives and investments are aimed at meeting the requirements of Application Providers of 3G Cellular and triple-play networks. If networking evolves toward greater emphasis on Application Providers, we believe we have positioned ourselves well relative to our key competitors. If it does not, however, our initiatives and investments in this area may be of no or limited value. As a result we cannot quantify the impact of new product introductions on our historical operations or anticipated impact on future operations.

In addition, as a result of the need to develop new and enhanced products, we expect to continue making investments in research and development before or after product introductions. Some of our research and development activities relate to long-term projects, and these activities may fail to achieve their technical or business targets and may be terminated at any point, and revenues expected from these activities may not be received for a substantial time, if at all.

Our inventory may become obsolete or unusable.

We make advance purchases of various component parts in relatively large quantities to ensure that we have an adequate and readily available supply. Our failure to accurately project our needs for these components and the demand for our products that incorporate them, or changes in our business strategy or technology that reduce our need for these components, could result in these components becoming obsolete prior to their intended use or otherwise unusable in our business. This would result in a write-off of inventories for these components. For example, in 2003 we wrote off \$960,000 of inventory which we determined to be obsolete.

Any reversal or slowdown in deregulation of telecommunications markets could materially harm the markets for our products.

Future growth in the markets for our products will depend, in part, on the continued privatization, deregulation and the restructuring of telecommunications markets worldwide, as the demand for our products is generally higher when a competitive environment exists. Any reversal or slowdown in the pace of this privatization, deregulation or restructuring could materially harm the markets for our products. Moreover, the consequences of deregulation are subject to many uncertainties, including judicial and administrative proceedings that affect the pace at which the changes contemplated by deregulation occur, and other regulatory, economic and political factors. Furthermore, the uncertainties associated with deregulation have in the past, and could in the future, cause our customers to delay purchasing decisions pending the resolution of these uncertainties.

Our business could be harmed if we were to lose the services of one or more members of our senior management team, or if we are unable to attract and retain qualified personnel.

Our future growth and success depends to a significant extent upon the continuing services of our executive officers and other key employees. We do not have long-term employment agreements or non-competition agreements with any of our employees. Competition for qualified management and other high-level telecommunications industry personnel is intense, and we may not be successful in attracting and retaining qualified personnel. If we lose the services of any key employees, we may not be able to manage our business successfully or to achieve our business objectives.

Our success also depends on our ability to identify, attract and retain qualified technical, sales, finance and management personnel. We have experienced, and may continue to experience, difficulties in hiring and retaining candidates with appropriate qualifications. If we do not succeed in hiring and retaining candidates with appropriate qualifications, our revenues and product development efforts could be harmed.

We may lose significant market share as a result of intense competition in the markets for our existing and future products.

Many companies compete with us in the market for network testing and service monitoring solutions. We expect that competition will increase in the future, both with respect to products that we currently offer and products that we are developing. Moreover, manufacturers of data communications and telecommunications equipment, which are current and potential customers of ours, may in the future incorporate into their products capabilities similar to ours, which would reduce the demand for our products. In addition, affiliates of ours that currently provide services to us may, in the future, compete with us.

Many of our existing and potential competitors have substantially greater resources, including financial, technological, engineering, manufacturing and marketing and distribution capabilities, and several of them may enjoy greater market recognition than us. We may not be able to compete effectively with our competitors. A failure to do so could adversely affect our revenues and profitability.

We are dependent upon the success of distributors who are under no obligation to distribute our products.

We are highly dependent upon our distributors for their active marketing and sales efforts and for the distribution of our products. Many of our distributors outside of North America are the only entities engaged in the distribution of our products in their respective geographical areas. Typically, our arrangements with them do not prevent our distributors from distributing competing products, or require them to distribute our products in the future. Our distributors may not give a high priority to marketing and supporting our products. Our results of operations could be materially adversely affected by changes in the financial situation, business or marketing strategies of our distributors. Any such changes could occur suddenly and rapidly.

We may lose customers and/or distributors on which we currently depend and we may not succeed in developing new distribution channels.

We have one customer in North America who accounted for more than 10% of our sales in 2005. If we were to lose this customer or if this customer were to reduce, delay or cancel its orders, our operating results could be harmed.

Our seven largest distributors in Europe and Asia accounted for a total of approximately 30.1% of our sales in 2003, 47.2% of our sales in 2004, and 36.1% of our sales in 2005. Two of our largest distributors in Europe each accounted for more than 10% of our sales in 2004 and one of our largest distributors in Europe accounted for about 10% of our sales in 2005. If we terminate or lose any of our distributors or if they downsize significantly, we may not be successful in replacing them on a timely basis, or at all. Any changes in our distribution and sales channels, particularly the loss of a major distributor or our inability to establish effective distribution and sales channels for new products, will impact our ability to sell our products and result in a loss of revenues.

We could be subject to warranty claims and product recalls, which could be very expensive and harm our financial condition.

Products as complex as ours sometimes contain undetected errors. These errors can cause delays in product introductions or require design modifications. In addition, we are dependent on other suppliers for key components incorporated in our products. Defects in systems in which our products are deployed,

whether resulting from faults in our products or products supplied by others, due to faulty installation or any other cause, may result in customer dissatisfaction, product return and, potentially, product liability claims being filed against us. Our warranties permit customers to return defective products for repair. The warranty period is typically one to two years. Any failure of a system in which our products are deployed (whether or not our products are the cause), any product recall, or product liability claims with any associated negative publicity, could result in the loss of, or delay in, market acceptance of our products and harm our business.

We depend on limited sources for key components and if we are unable to obtain these components when needed, we will experience delays in manufacturing our products.

We currently obtain key components for our products from either a single supplier or a limited number of suppliers. We do not have long-term supply contracts with any of our existing suppliers. This presents the following risks:

- Delays in delivery or shortages in components could interrupt and delay manufacturing and result in cancellations of orders for our products.
 - Suppliers could increase component prices significantly and with immediate effect.
 - We may not be able to locate alternative sources for product components.
- Suppliers could discontinue the manufacture or supply of components used in our products. This may require us to modify our products, which may cause delays in product shipments, increased manufacturing costs and increased product prices.
- We may be required to hold more inventory than would be immediately required in order to avoid problems from shortages or discontinuance.

We have experienced delays and shortages in the supply of components on more than one occasion in the past. This resulted in delays in our delivering products to our customers.

We depend on a limited number of independent manufacturers, which reduces our ability to control our manufacturing process.

We rely on a limited number of independent manufacturers, some of which are small, privately held companies, to provide certain assembly services to our specifications. We do not have any long-term supply agreements with any third-party manufacturer. If our assembly services are reduced or interrupted, our business, financial condition and results of operations could be adversely affected until we are able to establish sufficient assembly services supply from alternative sources. Alternative manufacturing sources may not be able to meet our future requirements, and existing or alternative sources may not continue to be available to us at favorable prices.

If we do not effectively manage our growth, our business and operating results could be adversely affected.

Our growth has placed, and is expected to continue to place, significant demands on our management, administrative and operational resources. To manage expansion effectively, we need to continue to develop and improve our operational and financial systems, sales and marketing capabilities and expand, train, retain, manage and motivate our employee base. Our systems, procedures or controls may not be adequate to support our operations and our management may not be able to successfully exploit future market opportunities or successfully manage our relationships with customers and other third parties. We may not continue to grow and, if we do, we may not effectively manage such growth. Any failure to manage growth could have an adverse effect on our business, financial condition and results of operations.

Our proprietary technology is difficult to protect and unauthorized use of our proprietary technology by third parties may impair our ability to compete effectively.

Our success and ability to compete depend in large part upon protecting our proprietary technology. We rely upon a combination of contractual rights, software licenses, trade secrets, copyrights, nondisclosure agreements and technical measures to establish and protect our intellectual property rights in our products and technologies. In addition, we sometimes enter into non-disclosure and confidentiality agreements with our employees, distributors and manufacturers' representatives, and certain suppliers with access to sensitive information. However, we have no registered patents, and these measures may not be adequate to protect our technology from third-party infringement. Moreover, pursuant to current U.S. and Israeli laws, we may not be able to enforce existing non-competition agreements. Additionally, effective trademark, patent and trade secret protection may not be available in every country in which we offer, or intend to offer, our products.

We are subject to litigation regarding infringement claims or claims that we have violated intellectual property rights which could seriously harm our business.

Third parties may from time to time assert against us infringement claims or claims that we have violated a patent or infringed a copyright, trademark or other proprietary right belonging to them. If such infringement were found to exist, we might be required to modify our products or intellectual property or obtain a license or right to use such technology or intellectual property. Any infringement claim, even if not meritorious, could result in the expenditure of significant financial and managerial resources. For example, on November 2, 2005, we were served with a claim by Qualitest Ltd., an Israeli company, which used to be a non-exclusive distributor of our products in Israel. The claim asserts that we breached an exclusive distribution agreement. On December 25, 2005, we filed a statement of defense asserting that an exclusive distribution agreement was never signed, and counterclaimed for unpaid invoices. The case has been brought before an arbitrator. We cannot predict our chances of success in this matter, and even if we prevail, the arbitration could result in the expenditure of significant financial and management resources.

Yehuda Zisapel and Zohar Zisapel, beneficially own approximately 32.1% of our ordinary shares and therefore have significant influence over the outcome of matters requiring shareholder approval, including the election of directors.

As of March 28, 2006, Yehuda Zisapel and Zohar Zisapel (our Chairman of the Board of Directors), who are brothers, beneficially owned an aggregate of 5,192,362 ordinary shares, representing approximately 32.1% of the ordinary shares. As a result, Yehuda Zisapel and Zohar Zisapel have significant influence over the outcome of various actions that require shareholder approval, including the election of our directors. In addition, Yehuda Zisapel and Zohar Zisapel may be able to delay or prevent a transaction in which shareholders might receive a premium over the prevailing market price for their shares and prevent changes in control of management.

We engage in transactions, and compete, with companies controlled by Yehuda Zisapel and Zohar Zisapel, which may result in potential conflicts.

We are engaged in and expect to continue to be engaged in numerous transactions with companies controlled by Yehuda Zisapel and Zohar Zisapel. We believe that such transactions are beneficial to us and are generally conducted upon terms which are no less favorable to us than would be available from unaffiliated third parties. Nevertheless, these transactions may result in a conflict of interest between what is best for us and the interests of the other parties in such transactions. In addition, several products of such affiliated companies may be used in place of our products, and it is possible that direct competition between us and one or more of such affiliated companies may develop in the future. Moreover, opportunities to develop, manufacture, or sell new products (or otherwise enter new fields) may arise in the future and be pursued by one or more affiliated companies instead of or in competition with us. This could materially adversely affect our business and results of operations.

We may encounter difficulties with our international operations and sales which could affect our results of operations.

While we are headquartered in Israel, approximately 96.9% of our sales in 2004 and 96.6% of our sales in 2005 were generated outside of Israel, including in North America, Europe, Asia, South America and Australia. This subjects us to many risks inherent in international business activities, including:

- national standardization and certification requirements and changes in tax law and regulatory requirements;
- longer sales cycles, especially upon entry into a new geographical market;
 - export license requirements;
 - trade restrictions;
 - changes in tariffs;
 - currency fluctuations;
 - economic or political instability;
- greater difficulty in safeguarding intellectual property; and
- difficulty in managing overseas subsidiaries and international operations.

We may encounter significant difficulties in connection with the sale of our products in international markets as a result of one or more of these factors.

The ordinary shares issued to investors in the PIPE transaction and upon the exercise of the warrants issued in the PIPE transaction, and ordinary shares underlying our options, may be sold in the public market, which could materially adversely affect the market price of our ordinary shares and our ability to raise capital through an offering of securities.

In connection with a PIPE investment in 2004, we issued 3,851,540 ordinary shares and warrants to purchase 962,887 ordinary shares. As of March 28, 2006, all of the warrants had been exercised, and 3,269,415 ordinary shares issued in the PIPE transaction and upon exercise of the warrants remain in the hands of the investors and are subject to an effective shelf registration statement. In addition, as of March 28, 2006, options to purchase a total of 2,654,822 ordinary shares were outstanding, and an additional 945,945 ordinary shares issuable pursuant to options which may be granted under our stock option plans were reserved for issuance. All shares issued upon the exercise of these options will be immediately available for sale in the public market, subject to the terms of grant of the options. Sales of the ordinary shares issued in the PIPE transaction and upon exercise of the warrants that have not yet been sold, sales of the ordinary shares issuable upon exercise of the options, or even the prospect of such sales, could materially adversely affect the market price of our ordinary shares and our ability to raise capital through our offering of securities.

Any inability to comply with Section 404 of the Sarbanes-Oxley Act of 2002 regarding internal control attestation may negatively impact the report on our financial statements to be provided by our independent auditors.

We are subject to the reporting requirements of the Securities and Exchange Commission. The Securities and Exchange Commission, as directed by Section 404 of the U.S. Sarbanes Oxley Act of 2002, adopted rules requiring

U.S. public companies to include a report of management on the company's internal control over financial reporting in its annual report on Form 10 K or Form 20 F, as the case may be, that contains an assessment by management of the effectiveness of the company's internal control over financial reporting. In addition, the company's independent registered public accountants must attest to and report on management's assessment of the effectiveness of the company's internal control over financial reporting. Our management may not conclude that our internal controls over financial reporting are effective. Moreover, even if our management does conclude that our internal controls over financial reporting are effective, if the independent accountants are not satisfied with our internal controls, the level at which our controls are documented, designed, operated or reviewed, or if the independent accountants interpret the requirements, rules or regulations differently from us, they may decline to attest to our management's assessment or may issue a report that is qualified. Any of these possible outcomes could result in a loss of investor confidence in the reliability of our financial statements, which could negatively impact the market price of our shares.

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Under the recent SEC release/approval order, a foreign private issuer that is an "accelerated filer" and that files its annual reports on Form 20-F or Form 40-F, must begin to comply with the internal control over financial reporting and related requirements, as directed by Section 404 of the U.S. Sarbanes Oxley Act of 2002, in the annual report for its first fiscal year ending on or after July 15, 2006. A foreign private issuer that is not an accelerated filer under the Exchange Act Rule 12b-2 definition must begin to comply in its annual report for its first fiscal year ending on or after July 15, 2007.

Currently we are not an "accelerated filer" as we do not have the aggregate market value of \$75 million or more (the so-called "public float"). However, we will have to reexamine our market value on June 30, 2006.

The requirement to record an expense for our stock-based compensation plans, and the resultant ongoing accounting charges, will significantly reduce our reported net income and net income per share, and the price of our stock could drop significantly.

In December 2004, the Financial Accounting Standards Board ("FASB") issued Statement Number 123 (revised 2004) "Share-Based Payment", or "FAS No.123 (R)", which requires all companies to measure compensation expense for all share-based payments (including employee stock options) at fair value, and will be effective for public companies for annual reporting periods of fiscal years beginning after June 15, 2005. Our adoption of FAS No.123 (R) will require us to record an expense for stock-based compensation plans commencing in the first quarter of 2006 and will result in ongoing accounting charges that will significantly reduce our net income. See Note 12 of the Notes to Consolidated Financial Statements for further information.

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

As more fully described below in "Item 10-Taxation-United States Federal Income Tax Considerations-Passive Foreign Investment Company Status," if for any taxable year our passive income, or our assets which produce (or are held for the production of) passive income, exceed specified levels, we may be characterized as a passive foreign investment company for U.S. federal income tax purposes. This characterization could result in adverse U.S. tax consequences to our U.S. shareholders. U.S. shareholders should consult with their own U.S. tax advisors with respect to the U.S. tax consequences of investing in our ordinary shares.

Volatility of the market price of our ordinary shares could adversely affect us and our shareholders.

The market price of our ordinary shares has been and is likely to continue to be highly volatile and could be subject to wide fluctuations in response to numerous factors, including the following:

- market conditions or trends in our industry;
- political, economic and other developments in the State of Israel and world-wide;

- actual or anticipated variations in our quarterly operating results or those of our competitors;
- announcements by us or our competitors of technological innovations or new and enhanced products;
 - changes in the market valuations of our competitors;
 - announcements by us or our competitors of significant acquisitions;
- entry into strategic partnerships or joint ventures by us or our competitors; and
 - additions or departures of key personnel.

In addition, the stock market in general, and the market for Israeli and technology companies in particular, has been highly volatile. Many of these factors are beyond our control and may materially adversely affect the market price of our ordinary shares, regardless of our performance. Shareholders may not be able to resell their ordinary shares following periods of volatility because of the market's adverse reaction to such volatility and we may not be able to raise capital through an offering of securities.

Risks Relating to Our Location in Israel

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

We are incorporated under Israeli law and our principal offices and manufacturing and research and development facilities are located in the State of Israel. Political, economic and military conditions in Israel directly affect our operations. Since the establishment of the State of Israel in 1948, a number of armed conflicts have taken place between Israel and its Arab neighbors and a state of hostility, varying in degree and intensity, has led to security and economic problems for Israel. We could be adversely affected by hostilities involving Israel, the interruption or curtailment of trade between Israel and its trading partners, a significant increase in inflation, or a significant downturn in the economic or financial condition of Israel. Since October 2000, there has been a marked increase in hostilities between Israel and the Palestinians, which has adversely affected the peace process and has negatively influenced Israel's relationship with several Arab countries. Also, the political and security situation in Israel may result in certain parties with whom we have contracts claiming that they are not obligated to perform their commitments pursuant to force majeure provisions of those contracts. In January 2006, Hamas, an Islamic movement responsible for many attacks against Israelis, won the majority of the seats in the Parliament of the Palestinian Authority. The election of a majority of Hamas-supported candidates is expected to be a major obstacle to relations between Israel and the Palestinian Authority, as well as to the stability in the Middle East as a whole.

Since our manufacturing facilities are located exclusively in Israel, we could experience disruption of our manufacturing due to acts of terrorism or any other hostilities involving or threatening Israel. If an attack were to occur, any Israeli military response that results in the call to duty of the country's reservists (as further discussed below) could affect the performance of our Israeli facilities for the short term. Our business interruption insurance may not adequately compensate us for losses that may occur and any losses or damages incurred by us could have a material adverse effect on our business. We do not believe that the political and security situation has had any material impact on our business to date; however, we can give no assurance that it will have no such effect in the future.

Some neighboring countries, as well as certain companies and organizations, continue to participate in a boycott of Israeli firms and others doing business with Israel or with Israeli companies. We are also precluded from marketing our products to certain of these countries due to U.S. and Israeli regulatory restrictions. Because none of our revenue is currently derived from sales to these countries, we believe that the boycott has not had a material adverse effect on us. However, restrictive laws, policies or practices directed towards Israel or Israeli businesses could have an adverse

impact on the expansion of our business.

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All male adult citizens and permanent residents of Israel under the age of 51 are, unless exempt, obligated to perform up to approximately 31 days of military reserve duty annually. Additionally, these residents are subject to being called to active duty at any time under emergency circumstances. Many of our officers and employees are currently obligated to perform annual reserve duty. We believe that we have operated relatively efficiently given these requirements since we began operations and during the period of the increase in hostilities with the Palestinians since October 2000. However, we cannot assess what the full impact of these requirements on our workforce or business would be if the situation with the Palestinians changed, and we cannot predict the effect on our business operations of any expansion or reduction of these requirements.

We may be adversely affected if the rate of inflation in Israel exceeds the rate of devaluation of the New Israeli Shekel against the dollar, and by the strengthening of the value of the New Israeli Shekel against the dollar.

A portion of our expenses, primarily labor expenses, is incurred in New Israeli Shekels (NIS). As a result, we are exposed to the risk that the rate of inflation in Israel will exceed the rate of devaluation of the NIS in relation to the dollar or that the timing of this devaluation will lag behind inflation in Israel. Although in recent years the rate of devaluation of the NIS against the dollar exceeded the rate of inflation in Israel (a reversal from prior years, which reversal benefited us), we cannot predict any future trends. Both of these conditions result in higher dollar costs for our operations in Israel, adversely affecting our dollar-measured results of operations.

We currently benefit from government programs and tax benefits which may be discontinued or reduced.

We currently receive grants and tax benefits under Government of Israel programs. In order to maintain our eligibility for these programs and benefits, we must continue to meet specific conditions, including making specific investments in fixed assets and paying royalties with respect to grants received. In addition, some of these programs restrict our ability to manufacture particular products outside of Israel or transfer particular technology. If we fail to comply with these conditions in the future, the benefits received could be canceled and we could be required to refund any payments previously received under these programs, or pay increased taxes. The Government of Israel has reduced the benefits available under these programs in recent years and these programs and tax benefits may be discontinued or curtailed in the future. If we do not receive these grants in the future, we will have to allocate funds to product development at the expense of other operational costs. The amount, if any, by which our taxes will increase depends upon the rate of any tax increase, the amount of any tax benefit reduction and the amount of any taxable income that we may earn in the future. If the Government of Israel ends these programs and tax benefits, our business, financial condition and results of operations could be materially adversely affected.

Provisions of Israeli law may delay, prevent or make difficult a merger or acquisition of us, which could prevent a change of control and depress the market price of our shares.

The Israeli Companies Law generally requires that a merger be approved by a company's board of directors and by a majority of the shares voting on the proposed merger. Unless a court rules otherwise, the statutory merger will not be deemed approved if shares representing a majority of the voting power present at the shareholders meeting, and which are not held by the potential merger partner (or by any person who holds 25% or more of the shares of capital stock or the right to appoint 25% or more of the directors of the potential merger partner or its general manager) vote against the merger. Upon the request of any creditor of a party to the proposed merger, a court may delay or prevent the merger if it concludes that there is a reasonable concern that, as a result of the merger, the surviving company will be unable to satisfy its obligations. In addition, a merger may generally not be completed unless at least (i) 50 days have passed since the filing of the merger proposal with the Israeli Registrar of Companies by each of the merging companies, and (ii) 30 days have passed since the merger was approved by the shareholders of each of the parties to the merger.

Finally, Israeli tax law treats some acquisitions, such as stock-for-stock exchanges between an Israeli company and a foreign company less favorably than U.S. tax laws. For example, Israeli tax law may, under certain circumstances, subject a shareholder who exchanges his ordinary shares for shares in another corporation to taxation prior to the sale of the shares received in such a stock-for-stock swap.

These provisions of Israeli corporate and tax law and the uncertainties surrounding such law may have the effect of delaying, preventing or making more difficult a merger with us or acquisition of us. This could prevent a change of control over us and depress the market price of our ordinary shares which otherwise might rise as a result of such a change of control.

It may be difficult to (i) effect service of process, (ii) assert U.S. securities laws claims and (iii) enforce U.S. judgments in Israel against directors, officers and experts named in this annual report.

We are incorporated in Israel. All of our executive officers and directors named in this annual report are nonresidents of the United States, and a substantial portion of our assets and the assets of such persons are located outside the United States. Therefore, it may be difficult to enforce a judgment obtained in the United States against us or any of those persons or to effect service of process upon those persons. It may also be difficult to enforce civil liabilities under U.S. federal securities laws in original actions instituted in Israel.

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

Our ordinary shares are listed for trading on the NASDAQ Stock Market, or NASDAQ, and since February 20, 2006, on The Tel Aviv Stock Exchange, or TASE. Trading in our ordinary shares on these markets is made in different currencies (U.S. dollars on NASDAQ and New Israeli Shekels on TASE), and at different times (resulting from different time zones, different trading days and different public holidays in the United States and Israel). Actual trading volume on the TASE is expected to be lower compared with trading volume on NASDAQ, and as such could be subject to higher volatility. The trading prices of our ordinary shares on these two markets are expected to often differ, resulting from the factors described above, as well as differences in exchange rates. Any decrease in the trading price of our ordinary shares on one of these markets could cause a decrease in the trading price of our ordinary shares on the other market.

ITEM 4. INFORMATION ON THE COMPANY

A. HISTORY AND DEVELOPMENT OF THE COMPANY

RADCOM Ltd. was incorporated in 1985 under the laws of the State of Israel. Our principal executive offices are located at 24 Raoul Wallenberg Street, Tel Aviv 69719, Israel, and our telephone and fax numbers are 972-3-645-5055 and 972-3-647-4681, respectively. Our website is www.radcom.com. Information on our website and other information that can be accessed through it are not part of or incorporated by reference into this annual report. In 1993, we established a wholly-owned subsidiary in the United States, RADCOM Equipment, Inc., a New Jersey corporation. RADCOM Equipment, Inc. is located at 6 Forest Avenue, Paramus, New Jersey 07652 and its telephone number is (201) 518-0033. In 1996, we incorporated a wholly-owned subsidiary in Israel, RADCOM Investments (1996) Ltd., located at our office in Tel Aviv, Israel. In 2001, we established a wholly-owned subsidiary in the United Kingdom, RADCOM (UK) Ltd., a United Kingdom corporation. RADCOM (UK) Ltd. is located at 2440 The Quadrant Aztec West, Almondsbury Bristol, BS32 4AQ England, and its telephone number is 1454-878827.

B. BUSINESS OVERVIEW

GLOSSARY

3G	Third-generation digital cellular telecommunication.
Asynchronous Transfer Mode (ATM)	A cell-based network technology protocol that supports simultaneous transmission of data, voice and video typically at T1/E1 or higher speeds.
Code Division Multiple Access (CDMA)	A digital wireless technology that uses a modulation technique in which many channels are independently coded for transmission over a single wideband channel.
CDMA2000 1X (EV-DO)	A third-generation digital high-speed wireless technology for packet-based transmission of text, digitized voice, video, and multimedia that is the successor to CDMA.
Time Division Synchronous Code Division Multiple Access (TD-SCDMA)	A 3G mobile telecommunications standard, being pursued in the People's Republic of China by the Chinese Academy of Telecommunications Technology (CATT).
Global System for Mobile Communications (GSM)	A digital wireless technology that is widely deployed in Europe and, increasingly, in other parts of the world.
General Packet Radio Service (GPRS)	A packet-based digital intermediate speed wireless technology based on GSM. (2.5 generation)
Universal Mobile Telecommunications Service (UMTS)	A third-generation digital high-speed wireless technology for packet-based transmission of text, digitized voice, video, and multimedia that is the successor to GSM.
Voice Over IP (VoIP)	A telephone service that uses the Internet as a global telephone network.
IP Multimedia Subsystem (IMS)	An internationally recognized standard defining a generic architecture for offering Voice over IP and multimedia services to multiple-access technologies.
Triple Play	A marketing term for the provisioning of the three services: high-speed Internet, television (Video on Demand or regular broadcasts) and telephone service over a single broadband connection.
Internet Protocol TV (IPTV)	Transmitting video in IP packets. Also called "TV over IP," IPTV uses streaming video techniques to deliver scheduled TV programs or video on demand (VOD).

Protocol	A specific set of rules, procedures or conventions governing the format, means and timing of transmissions between two devices.
Session	A lasting connection between a user (or user agent) and a peer, typically a server, usually involving the exchange of many packets between the user's computer and the server. A session is typically implemented as a layer in a network protocol.

Overview

We provide innovative network test and service monitoring solutions for communications service providers and equipment vendors. We specialize in solutions for next-generation Cellular and Voice, Data and Video over IP networks. Our solutions are used to accelerate the development and installation of network equipment and to assure ongoing network service quality. Our products facilitate fault management, network service performance monitoring and analysis, troubleshooting and pre-mediation (the ability to collect network information for a third party application). We introduced our first test equipment solution in 1993 and currently offer the following solutions:

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Network Monitoring

Our award-winning Omni-Q is a unique, next-generation network testing, monitoring and performance management solution. The Omni-Q system consists of a powerful and user-friendly central management module and a broad range of intrusive and non-intrusive probes covering various networks and services, including VoIP, UMTS, CDMA, IPTV, IMS data and others. The Omni-Q's central management module is designed to exploit the unique capabilities and feature set of our probes. It consolidates captured information into a comprehensive, integrated network service view that facilitates performance monitoring, fault detection, and network and service troubleshooting.

Protocol Analyzers

Our award-winning network protocol analyzers offer the most powerful network analysis and test solutions available to the Cellular, VoIP and data communications industry. Our network analyzers support over 600 protocols with multiple interfaces, allowing users to troubleshoot and analyze the most complex and advanced networks, quickly and simply.

Our strategy

Our objective is to become a market leader in network test and service monitoring solutions. To this end, we seek to deliver customer-oriented, technically advanced and cost-effective products and to support them according to world-class standards. Key elements of our strategy include:

- Capitalizing on the growth in the Cellular network and the move of wireline networks to IP technology markets and their associated monitoring needs;
- Leveraging our top-tier customer base and broad distribution channels to gain access to the service providers who are offering these new technologies;
 - Broadening our penetration of major service providers and vendors;
 - Extending our sales capabilities and distribution channels;
 - Repeat sales to our existing customers;
- Leveraging our experience and knowledge in the area of converged networks and technology platforms to produce comprehensive testing and analysis solutions for triple-play networks; and
- Maintaining technological leadership through products that address the needs of emerging technology markets.

Our sales network includes North America through our wholly-owned U.S. subsidiary, RADCOM Equipment, Inc., a sales office in China and, in the rest of the world, a network of more than 45 distributors selling in over 45 countries. RADCOM Equipment sells our products to end-users through a direct sales force and through 11 independent manufacturer's representatives. Our testing and monitoring equipment has been sold to a number of international companies and government agencies, including Hutchison, British Telecom, Telstra, Deutsche Telekom, Verizon wireless, Vodafone, KPN, Nortel Networks, Lucent, Siemens, Cisco, NTT, NEC, Nokia, ZTE, Huawei, Detang, Alcatel and Ericsson.

Industry Background

Service providers deploy unified, packet-based platforms with broadband and 3G technologies to enhance the value proposition of converged networks. These technologies allow service providers to offer new types of

revenue-enhancing services, such as voice calls, video calls, video streaming, IPTV, music downloading and messaging solutions. Mainstream deployment of converged networks has begun and equipment vendors are under pressure to develop and improve the required technologies. Both types of our main market players equipment vendors and service providers need sophisticated testing solutions. Equipment vendors need these solution to speed time-to-market while achieving the highest standard of products, and service providers need to evaluate vendors' products and to monitor customer experience and quality of service (QoS) on an ongoing basis. As such, the number of new testing and monitoring needs is growing.

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Products and Solutions

We categorize our products into two primary lines: (i) the Performer family, including the Omni-Q network monitoring solution, and (ii) the Prism series of multitechnology analyzers.

The Performer Family

The Performer family is an open platform that supports a wide range of test applications over a variety of technologies. With simplified control from a central console, the Performer hardware and software suite tests the quality and grade of service of a real-world network environment. The Performer family is a PC-based system, utilizing our generic analyzer processor, or GEAR-based, hardware. Our GEAR (GenEric AnalyzeR processor) chip is the main differentiating technology for us. It is a proprietary, one-chip analyzer processor designed to provide wirespeed testing performance, independent of protocols and technologies, on all layers. The GEAR processor positions us as the industry leader in the high-performance, communication test-equipment market. It allows one platform to carry out both network troubleshooting and analysis as well as packet and cell analysis in real time, at up to 2.5 Gbps, with no limitation on interface type or protocols. The GEAR technology also allows us to rapidly develop and roll out new interfaces by merely adding a new interface with the appropriate functionality. The Performer family is unique for its combination of strong hardware performance and flexible software use.

The Performer's architectural advantages include:

- **Single Platform:** Our single-platform technology enables all functions to be performed on one platform, as opposed to the multi-system architecture of its competitors.
- **Scalable:** Our systems are fully scalable, can migrate quickly to new applications, and can be easily integrated with third party applications.
- **Distributed system:** Our solution is based on a GPS synchronization technology, IP connectivity and management console/server architecture.

The Performer family response to customer needs is twofold:

- Post-deployment/quality management solutions and troubleshooting for convergence service providers, and
 - Pre-deployment, predictive test systems for convergence vendors.

Our system solutions are critical for the successful rollout of next-generation 3G Cellular networks, Voice over IP and Video over IP technologies. Our solutions lead the market in their ability to troubleshoot connectivity problems and analyze network performance, helping equipment vendors and service providers to ensure a trouble-free network environment and a high-quality user experience. We continuously extend our solutions in response to rapidly changing technology and customer requirements, evolving industry standards, and frequent new product introductions. In addition, our ability to provide highly cost-effective solutions has been a critical asset in this competitive market. With our combination of unique system solutions, nimble corporate structure and broad vision, we are positioned to anticipate and meet the future needs of our customers.

Network Protocol Analyzer

The Performer's innovative approach provides customers with real-time cell and packet analysis and troubleshooting capabilities at all seven telecommunications layers, including, basic physical and link layer testing, complex tracing of NAS layer voice, IP session signaling and data/voice quality of service validation. This analyzer supports Ethernet, WAN, ATM and POS interfaces, and can decode over 600 communication protocols. A fully distributed system, the Network Protocol Analyzer is an ideal solution for vendor research and development, quality assurance and integration labs, as well as for use by operators during network setup and operation for protocol verification, cell/frame-level analysis, voice call and IP session analysis and streaming media and voice quality testing.

The Cellular Performer

The Cellular Performer is an application that runs on our Performer platform launched in February 2003. The Cellular Performer is a multi-layer session-level analysis of applications and services that gives users a simple, intuitive and powerful troubleshooting tool. Used for drilling down to each of a cellular network's interfaces, our cellular protocol analysis tools enable users to trace a call over a whole network, and identify the source of network problems. This allows users to quickly pinpoint specific problems, and to smooth out the performance of highly complex networks. The product supports all major 2.5 and third generation networks, including GPRS, UMTS, CDMA2000, Enhanced Data Rates for Global Revolution Standard (Edge), and Time Division Synchronous CDMA (TD-SCDMA).

The Network Consultant is an advanced cellular network analysis application that enables mobile operators to quickly verify subscriber connectivity and proactively monitor end-to-end network performance. The Network Consultant gathers and processes data from multiple server links from the Radio Access Network, Core signaling, and Core IP. It enables full drill-down analysis capabilities of the call session, voice calls and video calls. Using it, customers can zoom in and view the signaling and procedures on each interface separately, online and offline.

The Voice-over-IP Performer

The Voice-over-IP Performer is designed to support pre-deployment testing of current and emerging convergence technologies. The Voice-over-Data Performer is the first performance testing solution that we launched.

The following are some of the highlights of the Voice-over-IP Performer:

- **MediaPro**— A real-time hardware-based, multi-protocol, multi-technology VoIP and Video analyzer, capable of analyzing a wide variety of VoIP signaling protocols and media CODECs.
- **QPro**— The QPro is a multi-technology call quality analyzer that enables users to test many call quality parameters over a variety of interfaces.
- **SIPSim**— The SIPSim is a SIP services load generator that focuses on high-stress load testing of any SIP application. The SIPSim provides highest industry performance while retaining the flexibility needed to emulate all types of services. By emulating up to hundreds of thousands of users over the SIPSim's Triple M' capability (multi-IP, multi-MAC and multi-VLAN), any service can be emulated over any type of network configuration. The SIPSim is capable of stress-testing different SIP services and network elements.
- **H.323Sim**—a voice-over-IP generator that generates over 2000 calls simultaneously, at the rate of over 100,000 calls per hour, emulating the functionality of an H.323 terminal.

Omni-Q™ Network Monitoring Solution

The Omni-Q is a unique, comprehensive, next-generation network monitoring and services solution. The Omni-Q solution consists of a powerful and user-friendly central management server and a

broad range of intrusive and non-intrusive probes covering various networks and services, including VoIP, UMTS, CDMA, and data. These probes are based on the Performer family platform, enabling the Omni-Q to deliver full visibility at the session and application level (and not only at the single packet or message level), with full 7-layer analysis at a level of performance unparalleled in the industry. In addition, the Omni-Q benefits global telecommunications carriers, by providing end-to-end voice quality monitoring and management. The Omni-Q is designed to enable service providers and vendors to successfully face tremendous challenges in the coming years, including:

- Massive deployment of next-generation networks such as UMTS, CDMA2000 and triple-play.
- Integration of new architectures such as high-speed downlink packet access (HSDPA), high-speed uplink packet access (HSUPA), IMS, UMTS Release 6 and CDMA Rev' A or EVDV.
 - Successful delivery of advanced services such as VoIP, IPTV and video conferencing.
- Proactively managing call quality on existing and next-generation service providers' production networks, along with maintenance of high-availability, high-quality voice services over packet telephony.

Telecommunications Service Providers (Cellular and Wireline) use the Omni-Q in four main areas:

- Fault detection - to detect when there is a problem.
- Performance - to analyze the behavior of network components and customer network usage in order to understand trends, performance and optimization (to help identify faults before the customer complains).
 - Troubleshooting - to drill down to resolve specific issues.
- Pre-Mediation - to provide call detail records or CDR information to third-party operations support systems (OSS) or other solutions.

The Omni-Q is comprised of the following components:

- The Omni-Q's central management module is designed to take advantage of the unique capabilities and feature set of our platform by consolidating the monitoring and analysis information into a comprehensive, integrated view that enables visibility, fault detection, performance and troubleshooting.
- The Omni-Q VoIP monitoring solution gives service providers, ILECs and cable/MSOs complete visibility into the VoIP service running over the network, enabling early-stage fault detection, pre-emptive maintenance and optimization, and drill-down troubleshooting that leads to quick and easy fault resolution.
- The Omni-Q UMTS/CDMA2000 Network Monitoring gives cellular service providers complete visibility into their networks, enabling long-term real-time traffic analysis, fault detection, troubleshooting and data collection. It monitors and analyzes the performance of Radio Access, Core Signaling and Core IP components. It provides extensive and flexible Key Performance Indicators (KPIs) and Key Quality Indicators (KQIs) analyses with real-time alarms that allow operators to detect faults before their customers experience problems.

The Prism Series of Multitechnology Analyzers and others

Our PrismLite is designed to address the needs of field service engineers and quality assurance and research and development labs, both of equipment developers and service providers who may need to test the operation of equipment using multiple technologies simultaneously. The PrismLite is convenient for transporting to on-site

locations for the testing of internetworking problems. Starting in the first quarter of 2003, sales of the Prism series products for ATM and frame relay declined dramatically as our customers' transitioned to our new Performer product line.

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Another product is our PNNI simulation product, a software application used to test ATM switches running the Private Network to Network Interface (PNNI) protocol. This application runs on a standard PC platform and enables the user to graphically design PNNI networks and simulate the existence of a multi-tiered network in its interaction with the ATM switch.

The following table shows the breakdown of our consolidated sales for the calendar years 2003, 2004 and 2005 by product:

	Year ended December 31,		
	2003	2004	2005
	(in thousands)		
The Performer Family	\$ 7,593	\$ 13,574	\$ 21,040
Prism and others	\$ 3,610	\$ 2,481	\$ 1,300
Total	\$ 11,203	\$ 16,055	\$ 22,340

Sales and Marketing

We sell our products in North America through our wholly-owned U.S. subsidiary, RADCOM Equipment, Inc., which sells our products to end-users directly or through independent manufacturer's representatives. Most of these manufacturer's representatives have exclusive rights of distribution of our products in their respective geographical areas throughout North America (except some accounts and the Omni-Q our monitoring solution which we handle directly) and are compensated by us on a commission basis. The activities of our manufacturer's representatives and our other sales and marketing efforts in North America are coordinated by RADCOM Equipment, Inc.'s employees, who also provide product support to our North American customers. These representatives do not hold any of our inventory, and they do not buy products from us. Our representatives locate customers, provide a demo if needed (in which case they use our demo equipment), and in some cases they provide training to the end-users. The customers submit orders directly to our wholly owned subsidiary, RADCOM Equipment, Inc., which invoices the end-user customers and collects payment directly, and then pays commissions to the manufacturer's representative for the sales in their territory. The commission is between 12% and 15%, depending on the agreement RADCOM EQUIPMENT Inc. has with the individual manufacturer's representative.

Outside North America, we sell our products through a global network of distributors who market data communications-related hardware and software products. We currently have more than 45 independent distributors, some of whom have exclusive rights to sell our products in their respective geographical areas. We have opened regional sales support offices in China and Spain. These offices support our distributors in these regions. We continue to search for new distributors to penetrate new geographical markets or to better serve our target markets.

Our distributors serve as an integral part of our marketing and service network around the world. They offer technical support in the end user's native language, attend to customer needs during local business hours, organize user programs and seminars and, in some cases, translate our manuals and product and marketing literature into the local language. We have a standard contract with our distributors. Based on this agreement, sales to distributors are final, and distributors have no right of return or price protection. In certain circumstances, we have granted limited rights of return and in such situations, we do not recognize the revenue. The distributors do not need to disclose to us their customers' names, prices or date of order. To the best of our knowledge, a distributor places an order with us after it receives an order from its end-user, and does not hold our inventory for sale. Usually, we are not a party to the agreements between distributors and their customers. Distributors may hold products for a demo or as repair parts in order to keep their service agreement with a customer. According to our agreement with the distributors, a distributor generally should buy at least one demo unit in order to present the equipment to their customers. This is a final sale, and there are no rights of return. In practice, the distributors pay full price for the hardware of the demo unit, and we give them a special discount for the software and allow distributors to receive all new software packages as they are released. The distributor cannot sell this equipment to the end-user; the license is only for the distributor. We do not

consider this a benefit to the distributors since we sell only the demo systems with a special software discount.

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We focus a significant amount of our sales and marketing resources on our distributors, providing them with ongoing communications and support, and our employees regularly visit distributors' sites. We organize annual distributors' meetings to further our relationships with our distributors and familiarize them with our products. In addition, in conjunction with our distributors, we participate in exhibitions of our products worldwide, place advertisements in local publications, encourage exposure in the form of editorials in communications journals, and prepare direct mailings of flyers and advertisements. The table below shows the sales breakdown by territory:

	Year ended December 31, (approximate \$ in millions)			Year ended December 31, (in percentage)		
	2003	2004	2005	2003	2004	2005
North America	4.6	4.5	8.8	41.0%	27.7%	39.5%
Europe	4.1	8.5	8.6	36.4	53.1	38.5
Asia Pacific	2.2	2.3	3.3	20.0	14.3	14.8
Israel	0.1	0.5	0.8	0.8	3.1	3.6
Others	0.2	0.3	0.8	1.8	1.8	3.6
Total revenues	11.2	16.1	22.3	100.0%	100.0%	100.0%

Customer Service and Support

We believe that providing a high level of customer service and support to end-users is essential to the acceptance of our products. We offer a toll-free technical support help desk to our representatives in the United States and a technical support help desk to our distributors worldwide. We also support our customers via fax, email and cellular phone service, and provide additional technical information on our internet home page. We also offer an E-Learning system, which provides technical courses to our distributors, representatives and sales and technical support people at remote locations. These services are partially available to end-users. We regularly produce a newsletter which is sent to representatives and distributors, and we publish application notes and technical briefs for representatives, distributors and end-users to assist in using our products more efficiently.

In addition to our direct service and support activities, our representatives in North America and our distributors worldwide provide sales, service and technical support functions for our products in their respective territories to end-user customers. We organize annual technical seminars in Europe and the Far East every year to increase the technical knowledge of distributors in the use of our products.

Our products are designed and manufactured to meet standards required by our customers. We provide a free one-year software update for the Performer family and a free two-year software update for the Prism family, which includes bug-fixing solutions and a hardware warranty on our products. After the initial update period, our customers can purchase an extended warranty for one-, two- or three-year periods. The extended warranty includes full software updates, which are included in the software package dating from the customer's initial purchase of the products and full hardware repair of any faulty units. The cost of the extended warranty for the Performer family is based on a percentage of the overall cost of the product as an annual maintenance fee. For the Prism family the cost is fixed. We also provide a customer "hot line" for technical assistance.

Manufacturing and Suppliers

Our manufacturing facilities, which are located in Tel Aviv and Jerusalem, Israel, consist primarily of final assembly, testing and quality control. Electronic components and subassemblies are prepared by subcontractors according to our designs and specifications. Certain components used in our products are presently available from, or supplied by, only one source and others are only available from limited sources. In addition, some of the software packages which we include in our product line are being developed by unaffiliated subcontractors. The manufacturing processes and procedures are generally ISO 2000 certified.

Markets and Customers key benefits of our solutions are described below;

For Developers: Reduced time to market, reduced development costs, automated testing and application versatility from R&D to QA through final testing and field service.

For Service Providers/Enterprises:

- reduced quality degradation, reduced outages, improved network utilization, longer customer hold times;
- ability to employ fewer and less experienced maintenance staff due to the utilization of a single test system environment, controlled by a central console, ensuring ease of use and reduced learning curves;
- decreased support costs through centralized management, portable high-end solutions for in-depth troubleshooting, ability to offer premium SLAs and LOE (level of experience) parameters based on measurable parameters and all-inclusive, probe-based solution.

The market for our products consists of the following types of end-users:

Telecommunications Service Providers (Cellular and Wireline) are organizations responsible for providing telecommunications services. This group of companies uses our product in four main areas:

- Fault detection - to detect when there is a problem.
- Performance - to analyze the behavior of network components and customer network usage in order to understand trends, performance and optimization (to help identify faults before the customer complains).
- Troubleshooting - to drill down to resolve specific issues.
- Pre-Mediation - to provide call detail records or CDR information to third-party operations support systems (OSS) or other solutions.

Labs of Telecommunication Service Providers. This group of customers includes companies that buy specific equipment and networks from manufacturers, and provide services to their customers. Our products may be used by these customers to evaluate the quality and performance of this equipment and networks and verify the conformance and interoperability between vendors.

Data Communications and Telecommunications Equipment Developers and Manufacturers. This group of customers includes companies that develop, manufacture and market data communications and telecommunications equipment.

Research and Development

The industry in which we compete is subject to rapid technological developments, evolving industry standards, changes in customer requirements, and new product introductions and enhancements. As a result, our success, in part, depends upon our ability, on a cost-effective and timely basis, to continue to enhance our existing products and to

develop and introduce new products that improve performance and reduce total cost of ownership. In order to achieve these objectives, we work closely with current and

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potential end-users, distributors and manufacturer's representatives and leaders in certain data communications and telecommunications industry segments to identify market needs and define appropriate product specifications. We intend to continue developing products that meet key industry standards and to support important protocol standards as they emerge. Still, there can be no assurances that we will be able to successfully develop products to address new customer requirements and technological changes, or that such products will achieve market acceptance.

Our gross research and development costs were approximately \$5.6 million in 2003, \$5.2 million in 2004, and \$5.8 million in 2005, representing 49.9%, 32.6% and 26.0% of sales, respectively. Aggregate research and development expenses funded by the Office of the Chief Scientist were approximately \$2.0 million in 2003, \$1.7 million in 2004 and \$1.7 million in 2005. We expect to continue to invest significant resources in research and development.

As of December 31, 2005, our research and development staff consisted of 70 employees. Research and development activities take place at our facilities in Tel Aviv. We occasionally use independent subcontractors for portions of our development projects.

Israeli Office of the Chief Scientist

From time to time we file applications for grants under programs of the Office of the Chief Scientist of the Israeli Ministry of Industry, Trade and Labor, known as the Chief Scientist. Grants received under such programs are repaid through a mandatory royalty based on revenues from products incorporating know-how developed with the grants. This government support is contingent upon our ability to comply with certain applicable requirements and conditions specified in the Chief Scientist's programs and with the provisions of the "R&D Law" - the Law for the Encouragement of Research and Development in Industry, 1984 - and the regulations promulgated thereunder.

Under the R&D Law, research and development programs that meet the specified criteria and are approved by the research committee of the Chief Scientist are usually eligible for grants of up to 50% of certain approved expenditures of such programs, as determined by said committee.

In exchange, the recipient of such grants is required to pay the Chief Scientist royalties from the revenues derived from products incorporating know-how developed within the framework of each such program or derived from such program (including ancillary services in connection with such program), usually up to an aggregate of 100% of the dollar-linked value of the total grants received in respect of such program, plus interest. As of 2005, our royalty rate was 3.5%.

The Israeli government is currently in the process of formulating a proposed amendment to the royalty regulations promulgated under the R&D Law. The amendment is expected to include changes to the royalty rates, which would vary from company to company based on the amount of its revenues and the approval date of its program, up to a rate of 6%, and, as of 2006, to increase the rate of interest accruing on grants by 1% per year. The amendment is expected to be effective retroactive to January 1, 2006, although there is no assurance as to whether and when it will be adopted.

The R&D Law generally requires that the product developed under a program be manufactured in Israel. However, with the approval of the Chief Scientist, some of the manufacturing volume may be performed outside of Israel, provided that the grant recipient pays royalties at an increased rate, which may be substantial, and the aggregate repayment amount is increased, which increase might be up to 300% of the grant, depending on the portion of the total manufacturing volume that is performed outside of Israel. Effective April 1, 2003, the R&D Law also allows for the approval of grants in cases in which the applicant declares that part of the manufacturing will be performed outside of Israel or by non-Israeli residents and the research committee is convinced that doing so is essential for the execution of the program. This declaration will be a significant factor in the determination of the Office of the Chief Scientist as to whether to approve a program and the amount and other terms of benefits to be granted. For example, the increased royalty rate and repayment amount will be required in such cases.

The R&D Law also provides that know-how developed under an approved research and development program may not be transferred to another person or entity in Israel without the approval of the research committee. Such approval is not required for the sale or export of any products resulting from such research or development.

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

In June 2005, an amendment to the R&D Law came into effect, which is intended to make it more compatible with the global business environment by, among other things, relaxing restrictions on the transfer of manufacturing rights outside Israel and on the transfer of Chief Scientist-funded know-how outside of Israel. The amendment permits the Chief Scientist to approve the transfer of manufacturing rights outside Israel in exchange for an import of different manufacturing into Israel as a substitute, in lieu of the increased royalties. The amendment further permits, under certain circumstances and subject to the Chief Scientist's prior approval, the transfer of Chief Scientist-funded know-how outside Israel, in the following cases: (a) if the subject company pays to the Chief Scientist a portion of the sale price paid in consideration of such funded know-how; (b) if the subject company receives know-how from a third party in exchange for its funded know-how; or (c) if such transfer of funded know-how arises in connection with certain types of cooperation in research and development activities.

The funds available for Chief Scientist grants made out of the annual budget of the State of Israel were reduced in 1998, and the Israeli authorities have indicated in the past that the government may further reduce or abolish the Chief Scientist grants in the future. Even if these grants are maintained, we cannot presently predict the amounts of future grants, if any, that we might receive. In each of the last ten fiscal years, we have received such royalty-bearing grants from the Chief Scientist. At December 31, 2005, our contingent liability to the Office of the Chief Scientist in respect of grants received was approximately \$19.8 million.

Binational Industrial Research and Development Foundation

We received from the BIRD Foundation funding for the research and development of products. At December 31, 2005, our contingent liability to the Bird Foundation in respect of funding received was approximately \$300,000. We have not received grants from the BIRD Foundation since 1995.

Proprietary Rights

To protect our rights to our intellectual property, we rely upon a combination of trademarks, contractual rights, trade secret law, copyrights, nondisclosure agreements and technical measures to establish and protect our proprietary rights in our products and technologies. We own registered

trademarks for the names PrismLite, Omni-Q, MediaPro and Wirespeed. In addition, we sometimes enter into non-disclosure and confidentiality agreements with our employees, distributors and manufacturer's representatives and with certain suppliers with access to sensitive information. However, we have no registered patents or trademarks (except for those listed above) and these measures may not be adequate to protect our technology from third-party infringement, and our competitors may independently develop technologies that are substantially equivalent or superior to ours.

Given the rapid pace of technological development in the communications industry, there also can be no assurance that certain aspects of our internetworking test solutions do not or will not infringe on existing or future proprietary rights of others. Although we believe that our technology has been independently developed and that none of our technology or intellectual property infringes on the rights of others, from time to time third parties may assert infringement claims against us. If such infringement is found to exist, or if infringement is found to exist on existing or future proprietary rights of others, we may be required to modify our products or intellectual property or obtain the requisite licenses or rights to use such technology or intellectual property. However, there can be no assurance that such licenses or rights can be obtained or obtained on terms that would not have a material adverse effect on us.

Competition

The markets for our products are very competitive and we expect that competition will increase in the future, both with respect to products that we are currently offering and products that we are developing. We believe that the principal competitive factors in the market for internetworking test and analysis equipment include:

- name recognition;
- product performance;
- supporting a combination of the right interfaces and protocols;
 - supporting the right services;
- quality of the software and the hardware;
 - technical features;
- multitechnology support;
 - portability;
 - price;
- customer service and support;
 - ease of use; and
- ability to export data to other information systems.

Our principal competitors are Agilent, Tektronix, NetHawk, Network Associates, Anritsu (Nettest), Acterna, SPIRENT Communications, Sunrise Telecom Inc., Empirix, Brix Networks and Minacom. In addition to these competitors, we expect substantial competition from established and emerging computer, communications, network management and test equipment companies. Many of these competitors have substantially greater resources than we have, including financial, technological, engineering, manufacturing and market and distribution capabilities, and

some of them may enjoy greater market recognition than we do.

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Employees

As of December 31, 2005, we had 115 permanent employees and 16 temporary employees located in Israel, 14 permanent employees of RADCOM Equipment, Inc. located in the United States and 7 permanent employees located in Spain and China collectively. Of the 131 employees located in Israel, 70 were employed in research and development, 20 in operations (including manufacturing and production), 28 in sales and marketing and 13 in administration and management. Of the 14 employees located in the U.S., 13 were employed in sales and marketing and 1 was employed in administration and management. Of the 7 employees located in Spain and China, all were employed in sales and marketing. We consider our relations with our employees to be good and have never experienced a labor dispute, strike or work stoppage. Substantially, all our employees have employment agreements and none of them is represented by a labor union. Our temporary employees are paid an hourly rate, have employment agreements and are not represented by a labor union.

Although we are not a party to a collective bargaining agreement, we are subject to certain provisions of general collective agreements between the Histadrut (General Federation of Labor in Israel) and the Coordinating Bureau of Economic Organizations (including the Industrialists' Association) that are applicable to our employees by virtue of expansion orders of the Israeli Ministry of Labor and Welfare. In addition, Israeli labor laws are applicable to all of our employees in Israel. These provisions and laws principally concern the length of the work day, minimum daily wages for workers, procedures for dismissing employees, determination of severance pay and other conditions of employment.

In Israel, a general practice we follow (although not legally required) is the contribution of funds on behalf of most of our permanent employees to an individual insurance policy known as "Managers' Insurance". This policy provides a combination of savings plan, insurance and severance pay benefits to the insured employee. It provides for payments to the employee upon retirement or death and accumulates funds on account of severance pay, if any, to which the employee may be legally entitled upon termination of employment. Each participating employee contributes an amount equal to 5% of such employee's base salary, and we contribute between 13.3% and 14.7% of the employee's base salary. Full-time employees who are not insured in this way are entitled to a savings account, to which each of the employee and the employer makes a monthly contribution of 5% of the employee's base salary. We also provide our permanent employees with an Education Fund, to which each participating employee contributes an amount equal to 2.5% of such employee's base salary and we contribute an amount equal to 7.5% of the employee's base salary. In the United States we provide benefits, in the form of health, dental, vision and disability coverage, in an amount equal to 14.49% of the employees' base salary. All Israeli employers, including us, are required to provide certain increases in wages as partial compensation for increases in the consumer price index. The specific formula for such increases varies according to the general collective agreements reached among the Manufacturers' Association and the Histadrut. Israeli employees and employers also are required to pay pre-determined sums (which include a contribution to national health insurance) to the Israel National Insurance Institute, which provides a range of social security benefits.

C. ORGANIZATIONAL STRUCTURE

In January 1993, we established our wholly-owned subsidiary in the United States, RADCOM Equipment, Inc., which conducts the sale and marketing of our products in North America. In July 1996, we incorporated a wholly-owned subsidiary in Israel, Radcom Investments (1996) Ltd., for the purpose of making various investments, including the purchase of securities. As of February 7, 2006, Radcom Investments did not hold any of our outstanding shares. In August 2001, we established our wholly-owned subsidiary in the United Kingdom, RADCOM (UK) Ltd., which conducts the sales and marketing of our products in the United Kingdom. In 2002, we established our wholly-owned Representative Office in China, which conducts the sales and marketing for our products in China. Our subsidiaries include:

<u>Name of Subsidiary</u>	<u>Jurisdiction of Incorporation</u>
RADCOM EQUIPMENT, Inc.	New Jersey
RADCOM Investments (1996) Ltd.	Israel
RADCOM (UK) Ltd.	United Kingdom

Yehuda Zisapel and Zohar Zisapel are co-founders and principal shareholders of our company. Individually or together, they are also founders, directors and principal shareholders of several other privately and publicly held high technology and real estate companies which, together with us and the other subsidiaries and affiliates, are known as the RAD-Bynet group. In addition to engaging in other businesses, members of the RAD-Bynet Group are actively engaged in designing, manufacturing, marketing and supporting data communications and telecommunications products. We have limited competition with RADVISION that supplies as part of their technology package a protocol simulation that may serve some of the needs of our customers for test equipment. Some of the products of members of the RAD-Bynet Group are complementary to, and have been and are currently used in connection with, our products.

D. PROPERTY, PLANTS AND EQUIPMENT

We do not own any real property. We currently lease an aggregate of approximately 2,278 square meters of office premises in Tel Aviv, which includes 2,106 square meters from affiliates of our principal shareholders. Our manufacturing facilities consist primarily of final assembly, testing and quality control of materials, wiring, subassemblies and systems. In 2005, aggregate annual lease and maintenance payments for the Tel Aviv premises were approximately \$479,000, of which approximately \$360,000 was paid to affiliates of our principal shareholders. We may, in the future, lease additional space from an affiliated party. We also lease premises in Paramus, New Jersey from an affiliate. In 2005, we leased approximately 8,946 square feet from an affiliate, of which we sub-lease a total of 3,091 square feet of which 2,815 square feet is leased to a third party and 276 square feet is leased to a related party. In 2005, aggregate annual lease payments for the premises were approximately \$166,000 and we received aggregate rental payments of approximately \$45,000 from the third party and \$5,000 from the related party for those sub-leases. In January 2006 we renewed our lease in Paramus, New Jersey. Currently we lease a total of 6,131 square feet, for aggregate annual lease payments of approximately \$115,000. We also lease approximately 144 square meters in Beijing. In 2005, our aggregate annual lease payments for those premises were approximately \$25,000. The rental agreements for the premises in Tel Aviv and New Jersey, United States, expire on December 31, 2008 and on January 15, 2011, respectively.

ITEM 4A. UNRESOLVED STAFF COMMENTS

Not applicable

ITEM 5. OPERATING AND FINANCIAL REVIEW AND PROSPECTS

The following discussion of our financial condition and results of operations should be read in conjunction with the consolidated financial statements and the related notes included elsewhere in this annual report.

This discussion contains forward-looking statements regarding future events and our future results that are subject to the safe harbors created under the Securities Act of 1933 and the Securities Exchange Act of 1934. These statements are based on current expectations, estimates, forecasts, and projections about the industries in which we operate and the beliefs and assumptions of our management. Words such as “expects,” “anticipates,” “targets,” “goals,” “projects,” “intends,” “plans,” “believes,” “seeks,” “estimates,” “continues,” “may,” variations of such words, and similar expressions are intended to identify such forward-looking statements. In addition, any statements that refer to projections of our future financial

performance, our anticipated growth and trends in our businesses, and other characterizations of future events or circumstances are forward-looking statements. Readers are cautioned that these forward-looking statements are only predictions and are subject to risks, uncertainties, and assumptions that are difficult to predict, including those identified below, as well as certain factors, including, but not limited to, those set forth in “Item 3-Key Information-Risk Factors.” Therefore, actual results may differ materially and adversely from those expressed in any forward-looking statements. We undertake no obligation to revise or update any forward-looking statements for any reason.

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Overview

We provide innovative network test and service monitoring solutions for communications service providers and equipment vendors. We specialize in solutions for next-generation Cellular and Voice, Data and Video over IP networks. Our solutions are used to accelerate the development and installation of network equipment and to assure ongoing network service quality. Our products facilitate fault management, network service performance monitoring and analysis, troubleshooting and pre-mediation (the ability to collect network information for a 3rd party application).

General

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

We commenced operations in 1991. Since then, we have focused on developing and enhancing our products, building our worldwide direct and indirect distribution network and establishing and expanding our sales, marketing and customer support infrastructure.

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

Our technology vision is based on an architectural evolution of networking from simple connectivity of products to application systems, or as we refer to it, the Application Provider. As such, many of our strategic initiatives and investments are aimed at meeting the requirements of Application Providers of 3G Cellular and triple-play networks. If networking evolves toward greater emphasis on Application Providers, we believe we have positioned ourselves well relative to our key competitors. If it does not, however, our initiatives and investments in this area may be of no or limited value. As a result we cannot quantify the impact of new product introductions on our historical operations or anticipated impact on future operations.

As we evaluate our growth prospects and manage our operations for the future, we continue to believe that the leading indicator of our growth will be the deployment of 3G Cellular and triple-play networks. During fiscal 2005, we continued to shift resources to the 3G Cellular segment and triple-play networks. While this potentially increases our exposure to changes in telecommunications industry conditions, we feel that this is a growing area and that we have the technology to capitalize on this market growth.

After commencing sales of our Performer in the first quarter of 2003, our revenues began to increase. By the end of 2005, our Performer family accounted for a full 89.7% of our revenues. In addition to the rise of 3G Cellular and triple-play network deployments, we began to record higher sales of our comprehensive monitoring solution. As a result of both of these developments, we enjoyed increased sales across all converged network product lines and the average size of our deals began to rise.

As we entered 2005, we articulated long-term financial priorities for seeking revenue growth while pursuing our profitability targets. Our results of operation for fiscal 2005 reflect these indicators. Net sales were \$22.3 million, compared with \$16.1 million in fiscal 2004. Net profit was \$1.5 million, compared with a net loss of \$1.7 million in fiscal 2004. We recorded a positive cash flow of \$1.7 million for 2005 compared to a net cash burn of \$2.2 million in 2004.

In 2006, we will continue to focus on our two major growth areas of 3G Cellular and triple-play networks with the goal of continuing to expand our sales and profits. With analysts projecting that the 3G market will eventually include 200-300 operators and an even larger number of next-generation wireline players, we believe there is a lot of room for additional growth. Having established momentum in North America and China, in 2006 we will increase our sales and marketing focus on Europe and the Far East, areas that offer us strong potential. Among the key external factors that will influence our 2006 performance are the continued improvement of the global telecommunications industry and our customers' perspective regarding the prospects for improving conditions. Although we believe that our products are unique fits for the needs of some of the industry's most rapidly growing segments, there can be no assurance that our sales will continue to increase.

Over the course of the fiscal year ended December 31, 2005, we saw further evidence of a recovery in the global telecommunications industry from the severe downturn that affected us in fiscal 2001 through 2003. This improvement in market conditions, coupled with increased capital spending by service providers, led to an increased rate of next-generation network deployment, and as a result an increased purchasing of our products by our customers in North America, Europe and the rest of the world.

Revenues. Our revenues are derived primarily from sales of our products and, to a lesser extent, from sales of post-contract customer support. Product revenues consist of gross sales of products, less discounts, refunds and returns.

Cost of sales. Cost of sales consists primarily of our manufacturing costs, warranty expenses, allocation of overhead expenses and royalties to the Chief Scientist. Since 2001, we have increasingly shifted to a subcontracting model for the manufacture of our products. The shift from a manufacturing model to a subcontracting model has occurred mainly in the Performer product line, and the bulk of the manufacturing of the Performer products is subcontracted out. Prior to 2001, the functions performed by us and subcontractors were divided as follows:

<u>RADCOM</u>	<u>Subcontractor</u>
Planning	Assembly
Purchase component parts	
Testing	
Integration	

As part of our plan to reduce product cost and improve manufacturing flexibility, we began to subcontract additional functions. Currently, the functions performed by us and subcontractors are divided as follows:

<u>RADCOM</u>	<u>Subcontractor</u>
Planning	Purchase component parts
Integration	Assembly
	Testing

Our subcontracting arrangements do not call for rolling forecasts. We provide a non-binding forecast every 12 months, and submit binding purchase orders quarterly for material needed in the next quarter. Purchase orders are generally filled within a month of placing the order. We are charged by the unit, which ensures that unnecessary charges for reimbursements are minimal. We are not required to reimburse subcontractors for losses that are incurred in providing services to us and there are no minimum purchase requirements in our subcontracting arrangements. If we change components in our products, however, and the manufacturer already bought components based on a purchase order, we would reimburse the manufacturer for any losses incurred relating to the manufacturer's disposal of such components. The subcontracting arrangements are governed by one-year contracts that are automatically renewable, and can be terminated by either party upon ninety days' written notice.

By reducing fixed manufacturing costs, we seek to ensure that our cost of goods sold fluctuates more directly in line with revenues.

Our gross profit is affected by several factors, including the introduction of new products, price erosion due to increasing competition, product mix and integration of other companies' solutions into our own. The cost of material and related gross profit for the Performer is almost identical to that of our other products. As a result, the introduction of the Performer is not expected to have a long-term impact on our gross margin. However, during the initial launch and manufacturing ramp-up of a new product, our gross profit is generally lower as a result of manufacturing inefficiencies during that period. As the difficulties in manufacturing new products are resolved and the volume of sales of such products increases, our gross profit generally improves. For example, in 2003, during the initial launch of the Performer, our gross profit was lower and subsequently improved.

Most of our products consist of a combination of hardware and software. Following an initial purchase of a product, a customer can add additional functions by purchasing software packages. These packages may add functions to the product such as providing additional testing data or adding the ability to test equipment based on different transmission technologies. Since there are no incremental hardware costs associated with the sale of the add-on software, the gross margins on these sales are higher. We also have higher gross profit on sales in North America, where we sell primarily through manufacturers' representatives, than on sales outside North America where we sell through distributors.

Research and Development. Research and development costs consist primarily of salaries and, to a lesser extent, payments to subcontractors, raw materials and overhead expenses. We use raw materials to build prototypes of our hardware and software products. These prototypes have no value since they cannot be sold or otherwise capitalized as inventory. The allocation of overhead expenses consists of a variety of costs, including rent, office expenses (including telecommunications expenses) and administrative costs, such as human resources activities. The methodology for allocating these expenses depends on the nature of the expense. Costs such as rent and associated costs are based on the square meters used by the R&D department. Administrative costs such as human resources activities are allocated based on the number of employees in the department. There has been no change in methodology from year to year. These expenses have been partially offset by royalty-bearing grants from the Chief Scientist.

Sales and Marketing. Sales and marketing expenses consist primarily of salaries, commissions to manufacturers' representatives, advertising, public relations, trade shows, promotional expenses, web site maintenance, public relations and overhead expenses.

General and Administrative Expenses. General and administrative expenses consist primarily of salaries and related personnel expenses for executive, accounting and administrative personnel, professional fees (which include legal, audit and additional consulting fees), bad debt expenses and other general corporate expenses.

Financial Income, Net. Financial income, net, consists primarily of interest earned on bank deposits, gains and losses from the exchange rate differences of monetary balance sheet items denominated in non-dollar currencies and interest

expenses paid on bank short-term loans.

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Future Additional Expense for Stock-Based Compensation

The Financial Accounting Standards Board (FASB) has concluded that Statement 123(R), Share-Based Payment, which will require all companies to measure compensation expense for all share-based payments (including employee stock options) at fair value, become effective for public companies for fiscal years beginning after June 15, 2005. As a result of FASB Statement 123(R) we are required to record an expense for stock-based compensation plans which will result in ongoing accounting charges that will significantly reduce our net income. See the section entitled “Stock-Based Compensation” in Note 12 of the Notes to our Consolidated Financial Statements, for further information.

Summary of Our Financial Performance in Fiscal 2005

Our financial performance in the year ended December 31, 2005 once again improved over our performance in the previous year: our revenues increased by 39.1% to \$22.3 million and our operating income increased to approximately \$1.3 million.

During fiscal 2005, our cash, cash equivalents and short-term investments increased by \$2.0 million, of which \$1.4 million was provided by operating activities. \$0.9 million was provided from the sale of stock under our stock option and employee share purchase and exercise of warrants. Capital expenditures in fiscal 2005 amounted to \$0.3 million.

Revenues. We experienced a significant rise in sales from quarter to quarter (year over year) throughout 2005, reflecting a significant increase in deals from major operators throughout the world with growing strength in North America, an important focus region for us. In North America we saw revenue increases of 98.1%, due to the continuing improvement in market conditions discussed above and our successful penetration into a large CDMA service provider.

Research and development. Since our future success will depend upon our ability to introduce new products addressing the changing demands of the telecommunications industry on a timely basis, we try to achieve a balance between the short-term and long-term challenges. Accordingly, in 2005 we scaled back our research and development workforce in a manner that we believe has not significantly affected our long-term development goals.

Sales and marketing. For marketing initiatives, we are taking advantage of the fact that potential customers for the Performer product line are larger and more well-known and that, as a result, our marketing efforts can be more focused. We focus on specific conferences rather than on general shows. Since the fourth quarter of 2004 we have seen a significant improvement in our booking and sales. In order to support this growing activity, we have increased our workforce and other expenses slightly in the areas of sales and marketing. In the Far East, we brought in an executive regional manager to begin addressing the significant opportunities in the region. In China, we built an infrastructure that enabled us to begin building the momentum of our sales and positioned us to take advantage of this very significant opportunity.

Organization of Our Business

Management receives sales information by product groups and by geographical regions. The cost of material and related gross profit for the Performer and the Prism is almost identical. Research and development, sales and marketing, and general and administrative expenses are reported on a combined basis only (i.e. are not allocated to product groups or geographical regions). Because a measure of operating profit or loss by product groups or geographical regions is not presented to the Company’s management, we have concluded that we operate in one reportable segment.

A. RESULTS OF OPERATIONS

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

	Year Ended December 31,		
	2003	2004	2005
Sales	100.0%	100.0%	100.0%
Cost of sales	43.7	31.9	33.1
Gross profit	56.3	68.1	66.9
Operating expenses:			
Research and development	49.9	32.6	26.0
Less royalty bearing participation	17.8	10.7	7.8
Research and development, net	32.1	21.9	18.2
Sales and marketing	66.1	43.5	35.3
General and administrative	14.5	13.6	7.6
Total operating expenses	112.7	79.0	61.1
Operating income (loss)	(56.4)	(10.9)	5.8
Financial income, net	0.8	0.5	1.0
Tax on Income	-	-	-
Net income (loss)	(55.6)	(10.4)	6.8

Financial Data for Year Ended December 31, 2005 Compared with Year Ended December 31, 2004 and Year Ended December 31, 2003

Revenues

	Year ended December 31, (approximate \$ in millions)			% Change 2004 vs.	% Change 2005 vs.
	2003	2004	2005	2003	2004
The Performer Family	7.6	13.6	21.0	78.9	54.4
Prism and others	3.6	2.5	1.3	(30.6)	(48.0)
Total revenues	11.2	16.1	22.3	43.8	38.5

Revenues. The increase in net sales in 2005 was primarily due to a significant rise in sales in North America. Our revenue increased 98.1% over 2004 due to the continuing improvement in market conditions discussed above and our successful penetration into a large CDMA service provider. In addition, with our award-winning Omni-Q solution, next-generation network testing, monitoring and performance management solution, we have successfully penetrated the service provider market. Due to the nature of the service provider orders which represents a potential for larger sales on average than do equipment vendors, the average size of our transactions began to increase.

Our sales network includes RADCOM Equipment, Inc., our wholly-owned subsidiary in the United States, as well as ten independent manufacturers' representatives, and more than 45 independent distributors in over 50 other countries. The table below shows the sales breakdown by territory:

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	Year ended December 31, (approximate \$ in millions)			Year ended December 31, (in percentage)		
	2003	2004	2005	2003	2004	2005
North America	4.6	4.5	8.8	41.0%	27.7%	