

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

FORM 6-K

**REPORT OF FOREIGN PRIVATE ISSUER PURSUANT TO RULE 13A-16 OR 15D-16
UNDER THE SECURITIES EXCHANGE ACT OF 1934**

For the month of March 2011
Commission File Number: 001-33129

Allot Communications Ltd.

(Translation of registrant's name into English)

**22 Hanagar Street
Neve Ne'eman Industrial Zone B
Hod-Hasharon 45240
Israel**

(Address of principal executive offices)

Indicate by check mark whether the registrant files or will file annual reports under cover Form 20-F or Form 40-F.

Form 20-F Form 40-F

Indicate by check mark if the registrant is submitting the Form 6-K in paper as permitted by Regulation S-T Rule 101(b)(1):

Indicate by check mark if the registrant is submitting the Form 6-K in paper as permitted by Regulation S-T Rule 101(b)(7):

Indicate by check mark whether by furnishing the information contained in this Form, the registrant is also thereby furnishing the information to the Commission pursuant to Rule 12g3-2(b) under the Securities Exchange Act of 1934.

Yes No

If "Yes" is marked, indicate below the file number assigned to the registrant in connection with Rule 12g3-2(b): 82- _____

EXPLANATORY NOTE

Filed herewith are Consolidated Financial Statements of Allot Communications Ltd. and its subsidiaries as of December 31, 2010 and Management's Discussion and Analysis of Financial Condition and Results of Operations for the year ended December 31, 2010.

SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

Allot Communications Ltd.

By: /s/ Nachum Falek

Nachum Falek
Chief Financial Officer

Date: March 31, 2011

EXHIBIT INDEX

The following exhibit has been filed as part of this Form 6-K:

<u>Exhibit</u>	<u>Description</u>
99.1	Consolidated Financial Statements of Allot Communications Ltd. and its subsidiaries as of December 31, 2010.
99.2	Management's Discussion and Analysis of Financial Condition and Results of Operations for the year ended December 31, 2010
99.3	Consent of Kost Forer Gabbay & Kasierer (a member of Ernst & Young global)

ALLOT COMMUNICATIONS LTD.

CONSOLIDATED FINANCIAL STATEMENTS

AS OF DECEMBER 31, 2010
U.S. DOLLARS IN THOUSANDS

ALLOT COMMUNICATIONS LTD.
CONSOLIDATED FINANCIAL STATEMENTS
AS OF DECEMBER 31, 2010
U.S. DOLLARS IN THOUSANDS

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REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Board of Directors and Shareholders of

ALLOT COMMUNICATIONS LTD.

We have audited the accompanying consolidated balance sheets of Allot Communications Ltd. ("the Company") as of December 31, 2010 and 2009, and the related consolidated statements of operations, shareholders' equity and cash flows for each of the three years in the period ended December 31, 2010. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the consolidated financial position of the Company at December 31, 2010 and 2009, and the consolidated results of its operations and its cash flows for each of the three years in the period ended December 31, 2010, in conformity with U.S. generally accepted accounting principles.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the Company's internal control over financial reporting as of December 31, 2010, based on criteria established in Internal Control-Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission and our report dated March 31, 2011 expressed an unqualified opinion thereon.

Haifa, Israel
March 31, 2011

/s/ KOST FORER GABBAY & KASIERER
KOST FORER GABBAY & KASIERER
A Member of Ernst & Young Global



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REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Shareholders and Board of Directors of

ALLOT COMMUNICATIONS LTD.

We have audited Allot Communications Ltd. ("the Company") and its subsidiaries internal control over financial reporting as of December 31, 2010, based on criteria established in Internal Control—Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (the COSO criteria). The Company's management is responsible for maintaining effective internal control over financial reporting, and for its assessment of the effectiveness of internal control over financial reporting . Our responsibility is to express an opinion on the Company's internal control over financial reporting based on our audit.

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. Our audit included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, testing and evaluating the design and operating effectiveness of internal control based on the assessed risk, and performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion.

A Company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A Company's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the Company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the Company are being made only in accordance with authorizations of management and directors of the Company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the Company's assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

In our opinion, the Company and its subsidiaries maintained, in all material respects, effective internal control over financial reporting as of December 31, 2010, based on the COSO criteria.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated balance sheets of the Company and its subsidiaries as of December 31, 2010 and 2009, and the related consolidated statements of operations, changes in Shareholders' equity and cash flows for each of the three years in the period ended December 31, 2010 and our report dated March 31, 2011 expressed an unqualified opinion thereon.

Haifa, Israel
March 31, 2011

/s/ KOST FORER GABBAY & KASIERER
KOST FORER GABBAY & KASIERER
A Member of Ernst & Young Global

CONSOLIDATED BALANCE SHEETS

U.S. dollars in thousands

	December 31,	
	2010	2009
ASSETS		
CURRENT ASSETS:		
Cash and cash equivalents	\$ 42,858	\$ 36,470
Restricted cash and deposits	1,060	1,060
Short-term bank deposits	-	1,264
Available-for-sale Marketable securities	15,531	-
Trade receivables (net of allowance for doubtful accounts of \$ 374 and \$ 253 at December 31, 2010 and 2009, respectively)	10,739	7,842
Other receivables and prepaid expenses	4,958	3,618
Inventories	10,830	5,046
Total current assets	85,976	55,300
NON-CURRENT ASSETS:		
Available-for-sale Marketable securities	-	14,490
Severance pay fund	162	3,410
Other assets	340	430
Total non-current assets	502	18,330
PROPERTY AND EQUIPMENT, NET	5,193	5,674
GOODWILL AND INTANGIBLE ASSETS, NET	3,516	3,639
Total assets	\$ 95,187	\$ 82,943

The accompanying notes are an integral part of the consolidated financial statements.

CONSOLIDATED BALANCE SHEETS

U.S. dollars in thousands, except share and per share data

	December 31,	
	2010	2009
LIABILITIES AND SHAREHOLDERS' EQUITY		
CURRENT LIABILITIES:		
Trade payables	\$ 5,140	\$ 3,142
Employees and payroll accruals	5,798	3,930
Deferred revenues	10,828	5,467
Other payables and accrued expenses	4,369	4,582
Total current liabilities	26,135	17,121
LONG-TERM LIABILITIES:		
Deferred revenues	3,873	2,046
Accrued severance pay	191	3,364
Total long-term liabilities	4,064	5,410
COMMITMENTS AND CONTINGENT LIABILITIES		
SHAREHOLDERS' EQUITY:		
Share capital -		
Ordinary shares of NIS 0.1 par value - Authorized: 200,000,000 shares at December 31, 2010 and 2009; Issued: 23,806,313 and 22,643,541 shares at December 31, 2010 and 2009, respectively; Outstanding: 23,806,313 and 22,397,062 shares at December 31, 2010 and 2009, respectively	527	492
Additional paid-in capital	133,483	128,476
Accumulated other comprehensive income (loss)	434	(4,862)
Accumulated deficit	(69,456)	(63,694)
Total shareholders' equity	64,988	60,412
Total liabilities and shareholders' equity	\$ 95,187	\$ 82,943

The accompanying notes are an integral part of the consolidated financial statements.

CONSOLIDATED STATEMENTS OF OPERATIONS

U.S. dollars in thousands, except share and per share data

	Year ended December 31,		
	2010	2009	2008
Revenues:			
Products	\$ 40,852	\$ 29,641	\$ 27,121
Services	16,120	12,110	9,980
Total revenues	56,972	41,751	37,101
Cost of revenues:			
Products	14,015	10,094	8,198
Services	1,970	1,741	1,498
Total cost of revenues	15,985	11,835	9,696
Gross profit	40,987	29,916	27,405
Operating expenses:			
Research and development (net of grants participations in the amount of \$2,774, \$2,440 and \$ 2,671 for the years ended December 31 2010, 2009 and 2008, respectively)	11,264	9,265	11,964
Sales and marketing	22,021	20,408	19,781
General and administrative	5,473	5,541	6,174
In-process research and development	-	-	244
Total operating expenses	38,758	35,214	38,163
Operating profit (loss)	2,229	(5,298)	(10,758)
Financial and other expenses, net	7,907	2,311	5,517
Loss before income tax expenses	(5,678)	(7,609)	(16,275)
Income tax expenses	84	63	220
Net loss	\$ (5,762)	\$ (7,672)	\$ (16,495)
Basic and diluted net loss per share	\$ (0.25)	\$ (0.35)	\$ (0.75)
Weighted average number of shares used in computing basic and diluted net loss per share	22,831,014	22,185,702	22,054,211

The accompanying notes are an integral part of the consolidated financial statements.

STATEMENTS OF CHANGES IN SHAREHOLDERS' EQUITY

U.S. dollars in thousands, except share data

	Ordinary shares		Additional paid-in capital	Accumulated other comprehensive income (loss)	Accumulated income (loss)	Total comprehensive loss	Total shareholders' equity
	Outstanding Shares	Amount					
Balance at January 1, 2008	22,008,249	\$ 480	\$ 123,913	-	\$ (47,208)	-	\$ 77,185
Exercise of stock options	58,868	2	88	-	-	-	90
Compensation related to options granted to non-employees	-	-	(198)	-	-	-	(198)
Stock-based compensation related to options granted to employees	-	-	1,900	-	-	-	1,900
Total comprehensive loss:							
Unrealized gain on hedging derivative instruments	-	-	-	697	-	697	697
Net loss	-	-	-	-	(16,495)	(16,495)	(16,495)
Total comprehensive loss						<u>\$ (15,798)</u>	
Balance at December 31, 2008	22,067,117	\$ 482	\$ 125,703	\$ 697	\$ (63,703)	-	\$ 63,179
Exercise of stock options	329,945	10	475	-	-	-	485
Compensation related to options granted to non-employees	-	-	58	-	-	-	58
Stock-based compensation related to options granted to employees	-	-	2,240	-	-	-	2,240
Total comprehensive loss:							
Cumulative effect from adoption of ASC No. 320	-	-	-	(7,681)	7,681	-	-
Unrealized loss on hedging derivative instruments	-	-	-	(85)	-	(85)	(85)
Unrealized gain on available-for-sale marketable securities	-	-	-	2,207	-	2,207	2,207
Net loss	-	-	-	-	(7,672)	(7,672)	(7,672)
Total comprehensive loss						<u>\$ (5,550)</u>	
Balance at December 31, 2009	<u>22,397,062</u>	<u>\$ 492</u>	<u>\$ 128,476</u>	<u>\$ (4,862)</u>	<u>\$ (63,694)</u>		<u>60,412</u>

The accompanying notes are an integral part of the consolidated financial statements.

STATEMENTS OF CHANGES IN SHAREHOLDERS' EQUITY

U.S. dollars in thousands, except share data

	Ordinary shares		Additional paid-in capital	Accumulated other comprehensive income (loss)	Accumulated income (loss)	Total comprehensive loss	Total shareholders' equity
	Outstanding Shares	Amount					
Exercise of stock options	1,244,051	35	3,017	-	-	-	3,052
Cashless exercise of options	165,200	*)	*)	-	-	-	-
Compensation related to options granted to non-employees	-	-	115	-	-	-	115
Stock-based compensation related to options granted to employees	-	-	1,875	-	-	-	1,875
Total comprehensive loss:							
Unrealized loss on hedging derivative instruments	-	-	-	(155)	-	(155)	(155)
Unrealized loss on available-for-sale marketable securities	-	-	-	(23)	-	(23)	(23)
Realized loss on available-for-sale marketable securities (see Note 4)	-	-	-	5,474	-	-	5,474
Net loss	-	-	-	-	(5,762)	(5,762)	(5,762)
Total comprehensive loss						<u>\$ (5,940)</u>	
Balance at December 31, 2010	<u>23,806,313</u>	<u>\$ 527</u>	<u>\$ 133,483</u>	<u>\$ 434</u>	<u>\$ (69,456)</u>		<u>\$ 64,988</u>

(*) Represents an amount lower than \$1

Accumulated other comprehensive income (loss)

	December 31, 2010	December 31, 2009
Accumulated unrealized loss on available-for-sale marketable securities	\$ (23)	\$ (5,474)
Accumulated unrealized gain on foreign currency cash flows hedges	457	612
Accumulated other comprehensive income (loss)	<u>\$ 434</u>	<u>\$ (4,862)</u>

CONSOLIDATED STATEMENTS OF CASH FLOWS

U.S. dollars in thousands

	Year ended December 31,		
	2010	2009	2008
<u>Cash flows from operating activities:</u>			
Net loss	\$ (5,762)	\$ (7,672)	\$ (16,495)
Adjustments to reconcile net loss to net cash used in operating activities:			
Depreciation	2,577	2,468	1,988
Write-off of property and of equipment, net	-	385	-
Stock-based compensation related to options granted to employees and non-employees	1,990	2,298	1,702
In-process research and development	-	-	244
Amortization of intangible assets	123	116	119
Capital loss (gain)	70	(108)	3
Decrease (increase) in accrued severance pay, net	75	(180)	261
Decrease in other assets	41	43	235
Decrease (increase) in accrued interest and amortization of premium on marketable securities	(189)	2	(27)
Decrease (increase) in trade receivables	(2,897)	(1,679)	20
Decrease (increase) in other receivables and prepaid expenses	(1,495)	(1,661)	2,564
Increase in inventories, net	(5,784)	(787)	(44)
Decrease (increase) in long-term deferred taxes	49	316	(101)
Increase (decrease) in trade payables	1,998	240	(507)
Increase (decrease) in employees and payroll accruals	1,868	606	(266)
Increase in deferred revenues	7,188	745	1,396
Increase (decrease) in other payables and accrued expenses	(213)	1,440	1,032
Realized loss related to sale of available-for-sale marketable securities	7,712	-	-
Other than temporary loss on marketable securities, net	-	3,036	7,700
Net cash provided by (used in) operating activities	<u>7,351</u>	<u>(392)</u>	<u>(176)</u>
<u>Cash flows from investing activities:</u>			
Cash paid in connection with the acquisition of Espion	-	-	(3,802)
Increase in restricted cash and deposits	-	(2)	(1,058)
Investments in short-term bank deposits	-	(201)	(1,001)
Redemption of short-term bank deposits.	1,264	-	-
Purchase of property and equipment	(2,334)	(3,608)	(1,720)
Proceeds from sale of property and equipment	168	159	-
Investment in available-for sale marketable securities	(16,765)	-	-
Proceeds from redemption or sale of available-for-sale marketable securities	<u>13,652</u>	<u>-</u>	<u>19,595</u>
Net cash provided by (used in) investing activities	<u>(4,015)</u>	<u>(3,652)</u>	<u>12,014</u>

The accompanying notes are an integral part of the consolidated financial statements.

CONSOLIDATED STATEMENTS OF CASH FLOWS

U.S. dollars in thousands

	Year ended December 31,		
	2010	2009	2008
<u>Cash flows from financing activities:</u>			
Exercise of stock options	3,052	485	90
Net cash provided by financing activities	3,052	485	90
Increase (decrease) in cash and cash equivalents	6,388	(3,559)	11,928
Cash and cash equivalents at the beginning of the year	36,470	40,029	28,101
Cash and cash equivalents at the end of the year	\$ 42,858	\$ 36,470	\$ 40,029
<u>Supplementary cash flow information:</u>			
(a) <u>Non-cash activities:</u>			
Increase in goodwill on account of earn out included in other liabilities and accrued expenses	-	-	\$ 186
(b) <u>Cash paid during the year for:</u>			
Interest	\$ -	\$ -	\$ 12
Taxes	\$ 168	\$ 80	\$ 69

The accompanying notes are an integral part of the consolidated financial statements.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

U.S. dollars in thousands, except share and per share data

NOTE 1:- GENERAL

Allot Communications Ltd. ("the Company") was incorporated in November 1996 under the laws of the State of Israel. The Company is engaged in developing, selling and marketing intelligent IP service optimization solutions for mobile, DSL and wireless broadband carriers, cable operator service providers, and enterprises. The Company's portfolio of hardware platforms and software applications utilizes advanced deep packet inspection technology to transform broadband pipes into smart networks that can rapidly and efficiently manage data over mobile and wireline networks and deploy value added Internet services. The Company's products consist of the Service Gateway and NetEnforcer traffic management systems, the NetXplorer and Subscribe Management Platform application management suites and value added services such as the Service Protector network protection solution, the MediaSwift video caching solution and the WebSafe network service.

The Company's Ordinary Shares are listed in the NASDAQ Global Select Market under the symbol "ALLT" from its initial public offering in November 2006. Since November, 2010, the Company's Ordinary Shares have been listed for trading also in the Tel Aviv Stock Exchange.

The Company holds six wholly-owned subsidiaries (the Company together with said subsidiaries shall collectively be referred to as "Allot"): Allot Communications, Inc. in Woburn, Massachusetts, United-States ("the U.S. subsidiary"), which was incorporated in 1997 under the laws of the State of California, Allot Communication Europe SARL in Sophia, France ("the European subsidiary"), which was incorporated in 1998 under the laws of France, Allot Communications Japan K.K. in Tokyo, Japan ("the Japanese subsidiary"), which was incorporated in 2004 under the laws of Japan, Allot Communication (UK) Limited ("the UK subsidiary"), which was incorporated in 2006 under the laws of England and Wales, Allot Communications (Asia Pacific) Pte. Ltd. ("the Singaporean subsidiary"), which was incorporated in 2006 under the laws of Singapore and Allot Communications (New Zealand) Limited. ("the NZ subsidiary"), which was incorporated in 2007 under the laws of New Zealand.

The U.S. subsidiary commenced operations in 1997. It is engaged in the sale, marketing and technical support services in the Americas of products manufactured and imported by the Company. The European, Japanese, UK and Singaporean subsidiaries are engaged in marketing and technical support services of the Company's products in Europe, Japan, UK and Asia Pacific, respectively. The NZ subsidiary commenced its operations in 2008 and is engaged in the research and development activities related to the Service Protector and technical support services for this product.

NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES

The consolidated financial statements have been prepared in accordance with U.S. generally accepted accounting principles ("U.S. GAAP").

a. Use of estimates:

The preparation of the consolidated financial statements in conformity with U.S. generally accepted accounting principles requires management to make estimates, judgments and assumptions. The Company's management believes that the estimates, judgments and assumptions used are reasonable based upon information available at the time they are made. These estimates, judgments and assumptions can affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the dates of the financial statements, and the reported amounts of revenue and expenses during the reporting period. Actual results could differ from those estimates.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

U.S. dollars in thousands, except share and per share data**NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES (CONT.)**

b. Financial statements in U.S. dollars:

The majority of the revenues of the Company and its subsidiaries are generated in U.S. dollars ("dollar") or linked to the dollar. In addition, a major portion of the Company's and certain of its subsidiaries' costs are incurred or determined in dollars. The Company's management believes that the dollar is the currency of the primary economic environment in which the Company and its subsidiaries operate. Thus, the functional and reporting currency of the Company and its subsidiaries is the dollar.

Accordingly, monetary accounts maintained in currencies other than the dollar are remeasured into U.S. dollars in accordance with Accounting Standards Codification No. 830, "Foreign Currency Matters" ("ASC No. 830"). All transactions gains and losses from the remeasurement of monetary balance sheet items are reflected in the statements of operations as financial income or expenses as appropriate.

c. Principles of consolidation:

The consolidated financial statements include the accounts of the Company and its subsidiaries. Intercompany balances and transactions have been eliminated upon consolidation.

d. Cash and cash equivalents:

The Company considers all unrestricted highly liquid investments which are readily convertible into cash, with maturity of three months or less at the date of acquisition, to be cash equivalents.

e. Restricted cash and deposits:

Restricted cash of \$ 1,000 and restricted deposits of \$ 60 are held in favor of financial institutions towards fulfillments of forward contract and operating obligations, respectively.

f. Short-term bank deposits:

Short-term bank deposits are deposits with maturities of more than three months but less than one year. The deposits are in dollars and New Israeli Shekels ("NIS") and bear interest at annual weighted average rate 1.5% at December 31, 2009. The short-term deposits are presented at cost, including accrued interest.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

U.S. dollars in thousands, except share and per share data

NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES (CONT.)

g. Marketable securities:

The Company accounts for its investments in marketable securities using Accounting Standards Codification No. 320, "Investments – Debt and Equity Securities" ("ASC No. 320").

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

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

In April 2009, the Company adopted the FASB's updated guidance relating to investments and debt securities, which amends the other-than-temporary impairment ("OTTI") guidance in U.S. GAAP. Under the updated guidance, if OTTI occurs, and it is more likely than not that the Company will not sell the investment or debt security before the recovery of its amortized cost basis, then the OTTI is separated into (a) the amount representing the credit loss and (b) the amount related to all other factors (provided that the Company does not intend to sell the security and it is not more likely than not that it will be required to sell it before recovery). The amount of the total OTTI related to credit loss is recognized in earnings. The amount of the total OTTI related to other factors is recognized in accumulated other comprehensive income. As a result of the adoption of this update accounting guidance, the Company recorded a cumulative effect adjustment of \$7,681 to reclassify the non-credit component of previously recognized impairments from accumulated deficit to accumulated other comprehensive income (loss).

As of December 31, 2009, the Company held marketable securities in U.S. dollars in the United States. The balance was composed of Auction Rate Securities ("ARS"). During 2010, the Company had sold its entire ARS portfolio, reclassified the loss recorded in accordance with ASC No. 320 in the accumulated other comprehensive loss in the amount of \$5,474 to financing expenses and recognized an additional loss of \$2,238, as further detailed in Notes 4 and 5.

h. Inventories:

Inventories are stated at the lower of cost or market value. Inventory write-offs are provided to cover risks arising from slow-moving items or technological obsolescence for which recoverability is not probable. Inventory write-offs due to slow moving items and technological obsolescence totaled \$ 1,100, \$ 800 and \$ 250 in 2010, 2009 and 2008, respectively.

Cost is determined as follows:

Raw materials - using the "first in, first out" (FIFO) cost method.

Finished goods - on the basis of raw materials, manufacturing cost and allocable indirect cost.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

U.S. dollars in thousands, except share and per share data

NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES (CONT.)

i. Property and equipment:

Property and equipment are stated at cost, net of accumulated depreciation. Depreciation is calculated by the straight-line method over the estimated useful lives of the assets at the following annual rates:

	<u>%</u>
Lab equipment	25-33
Computers and peripheral equipment	15-33
Office furniture	6-15
Leasehold improvements	By the shorter of term of the lease or the useful life of the asset

j. Goodwill impairment:

Goodwill represents the excess of the purchase price over the fair value of net assets of purchased businesses is recorded as goodwill. Under Accounting Standards Codification No. 350, "Intangibles-Goodwill and Other" ("ASC No. 350"), goodwill and intangible assets deemed to have indefinite lives are tested for impairment annually, or more often if there are indicators to impairment present.

The Company performs annual impairment analysis of goodwill at December 31 of each year, or more often as applicable. The provisions of ASC No. 350 require that a two-step impairment test be performed on goodwill at the level of the reporting units. In the first step, the Company compares the fair value of each reporting unit to its carrying value. If the fair value exceeds the carrying value of the net assets, goodwill is considered not impaired, and no further testing is required to be performed. If the carrying value of the net assets exceeds the fair value, then the Company must perform the second step of the impairment test in order to determine the implied fair value of goodwill. If the carrying value of goodwill exceeds its implied fair value, then the Company would record an impairment loss equal to the difference.

The Company believes that its business activity and management structure meet the criterion of being a single reporting unit for accounting purposes. The Company has performed an annual impairment analysis as of December 31, 2010 and determined that the carrying value of the reporting unit was less than the fair value of the reporting unit. In calculating the fair value of the reporting unit, the market approach was the methodology used. During years 2010, 2009 and 2008 no impairment losses were recorded.

k. Impairment of long-lived assets:

Long-lived assets are reviewed for impairment in accordance with Accounting Standards Codification No. 360, "Property, Plant, and Equipment", whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. The recoverability of assets to be held and used is measured by a comparison of the carrying amount of the assets to the future undiscounted cash flows expected to be generated by the assets. If such assets are considered to be impaired, the impairment to be recognized is measured by the amount by which the carrying amount of the assets exceeds the fair value of the assets. As of December 31, 2010, 2009 and 2008, no impairment losses were recorded.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

U.S. dollars in thousands, except share and per share data

NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES (CONT.)

l. Revenue recognition:

The Company generates revenues mainly from the sale of hardware and software products along with related maintenance and support services. The Company generally sells its products through resellers, distributors, OEMs and system integrators, all of whom are considered end-customers from The Company's perspective.

The software components of the Company's products are deemed to be more than incidental to the products as a whole, in accordance with Accounting Standards Codification No. 985-605, "Revenue Recognition" ("ASC No. 985-605"). Therefore, The Company accounts for its product sales in accordance with ASC No. 985-605. Revenues from product sales are recognized when persuasive evidence of an agreement exists, delivery of the product has occurred, no significant performance obligations with regard to implementation remain, the fee is fixed or determinable and collectability is probable.

ASC No. 985-605 generally requires revenue earned on software arrangements involving multiple elements to be allocated to each element based on the relative objective fair value of the elements. Accordingly, revenues are allocated to the different elements in the arrangement under "the residual method" when Vendor Specific Objective Evidence ("VSOE") of fair value exists for all undelivered elements and no VSOE exists for the delivered elements. Under the residual method, at the outset of the arrangement with a customer, The Company defers revenue for the fair value of its undelivered elements (maintenance and support) and recognizes revenue for the remainder of the arrangement fee attributable to the elements initially delivered in the arrangement (hardware and software products) when all other criteria in ASC No. 985-605 have been met. Any discount in the arrangement is allocated to the delivered element.

Maintenance and support related revenues included in multiple element arrangements are deferred and recognized on a straight-line basis over the term of the applicable maintenance and support agreement. The VSOE of fair value of the maintenance and support services is determined based on the price charged when sold separately. Deferred revenues are classified as short and long terms and recognized as revenues at the time respective elements are provided.

The Company provides a provision for product returns and stock rotation based on its experience with historical sales returns, stock rotations and other known factors.

The Company grants a one-year hardware and software warranty on all of its products. The Company estimates the costs that may be incurred under its warranty arrangements and records a liability in the amount of such costs at the time product revenue is recognized. Factors that affect the Company's warranty liability include the number of installed units, historical and anticipated rates of warranty claims and cost per claim. The Company periodically assesses the adequacy of its recorded warranty liabilities and adjusts the amounts as necessary.

m. Advertising expenses:

Advertising expenses are charged to the statement of operations, as incurred. Advertising expenses for the years ended December 31, 2010, 2009 and 2008 amounted to \$635, \$626 and \$426, respectively.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

U.S. dollars in thousands, except share and per share data**NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES (CONT.)**

n. Research and development costs:

Accounting Standards Codification No. 985, "Software" ("ASC No. 985"), requires capitalization of certain software development costs subsequent to the establishment of technological feasibility.

Based on the Company's product development process, technological feasibility is established upon the completion of a working model. The Company does not incur material costs between the completion of a working model and the point at which the products are ready for general release. Therefore, research and development costs are charged to the consolidated statement of operations as incurred.

o. Severance pay:

Until December 31, 2009, the Company liability for severance pay for its Israeli employees was calculated pursuant to Israel's Severance Pay Law, based on the most recent monthly salary of its employees multiplied by the number of years of employment as of the balance sheet date for such employees. Company's liability was partly provided by monthly deposits with severance pay funds and insurance policies and the remainder by an accrual.

During 2010, the Company decided that starting 2010 all employees severance pay liability will be calculated in accordance with section 14 of the Severance Pay Law -1963 (herein- "Section 14"), Section 14 states that Company's contributions for severance pay shall be instead of severance compensation and that upon release of the policy to the employee, no additional obligations shall be conducted between the parties regarding the matter of severance pay and no additional payments shall be made by the Company to the employee.

Further, for companies which have signed Section 14, related obligation and amounts deposits on behalf of such obligation, are not stated on the balance sheet, since they are legally released, based on court ruling, from obligation to employees once the deposit amounts have been paid.

At the date of the transition to Section 14, the Company transferred the entire amount of funds to cover its severance liability calculated based on the most recent monthly salary to the employees funds and thus Company's balance sheet as of December 31, 2010 does not include a liability or funds in connection with severance except for six employees who did not agree to the transition to Section 14 and for whom the liability and funds are still apply, since the Company legally obligated, based on method used before the implementation of Section 14.

Severance expenses for the years ended December 31, 2010, 2009 and 2008, amounted to \$ 925, \$ 991 and \$ 957, respectively.

p. Accounting for stock-based compensation:

The Company accounts for stock based compensation in accordance with Accounting Standards Codification No. 718, "Compensation - Stock Compensation" ("ASC No. 718") that requires companies to estimate the fair value of equity-based payment awards on the date of grant using an option-pricing model. The value of the portion of the award that is ultimately expected to vest is recognized as an expense over the requisite service periods in the Company's consolidated statement of operations.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

U.S. dollars in thousands, except share and per share data

NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES (CONT.)

p. Accounting for stock-based compensation (Cont.):

The Company applies ASC No. 718 and Accounting Standards Codification No. 505-50, "Equity-Based Payments to Non-Employees" ("ASC No. 505-50") with respect to options and warrants issued to non-employees. Accordingly, option valuation models to measure the fair value of the options and warrants at the measurement date as defined in ASC No. 505-50.

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

The following table sets forth the total stock-based compensation expense resulting from stock options granted to employees and non-employees included in the consolidated statements of operations, for the years ended December 31, 2010, 2009 and 2008:

	Year ended December 31,		
	2010	2009	2008
Cost of revenues	\$ 95	\$ 104	\$ 50
Research and development	352	357	321
Sales and marketing	851	775	465
General and administrative	692	1,062	866
<u>Total</u> stock-based compensation expense	<u>\$ 1,990</u>	<u>\$ 2,298</u>	<u>\$ 1,702</u>

The Company selected the binomial option pricing model as the most appropriate fair value method for its stock-based compensation awards (except for restricted-stock units, which are valued based on the market value of the underlying share at the date of grant) with the following assumptions for the year ended December 31, 2010, 2009 and 2008:

	Year ended December 31,		
	2010	2009	2008
Suboptimal exercise multiple	2.5-3.5	2.5-3.5	2 - 3.6
Risk free interest rate	0.25%-5.54%	0.31%-5.19%	1.07%-6.81%
Volatility	50%-52%	53%-60%	62% - 75%
Dividend yield	0%	0%	0%

The expected annual post-vesting and pre-vesting forfeiture rates affects the number of exercisable options. Based on the Company's historical experience, the annual post-vesting and pre-vesting forfeiture rates is 0%-14%.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

U.S. dollars in thousands, except share and per share data

NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES (CONT.)

p. Accounting for stock-based compensation (Cont.):

The computations of expected volatility and suboptimal exercise multiple are based on the average of the Company's realized historical stock price volatility and certain peer companies that the Company considered to be comparable based on market capitalization and type of technology platform. The computation of the suboptimal exercise multiple and the forfeiture rates are based on the grantees expected exercise prior and post vesting termination behavior. The interest rate for period within the contractual life of the award is based on the U.S. Treasury Bills yield curve in effect at the time of grant. The Company currently has no plans to distribute dividends and intends to retain future earnings to finance the development of its business.

The expected life of the stock options represents the weighted-average period the stock options are expected to remain outstanding and is a derived output of the binomial model. The expected life of the stock options is impacted by all of the underlying assumptions used in the Company's model.

q. Concentration of credit risks:

Financial instruments that potentially subject the Company to concentrations of credit risk consist primarily of cash and cash equivalents, restricted cash and deposits, marketable securities, short-term bank deposits, trade receivables and derivative instruments.

The majority of cash and cash equivalents, restricted cash and deposits, marketable securities and short-term deposits of the Company are invested in dollar deposits in major U.S. and Israeli banks. Such deposits in the United States may be in excess of insured limits and are not insured in other jurisdictions. Generally, the cash and cash equivalents and short-term bank deposits may be redeemed upon demand, and therefore, bear minimal risk.

The Company's trade receivables are primarily derived from sales to customers located mainly in the United States, Europe and Asia. Concentration of credit risk with respect to trade receivables is limited by credit limits, ongoing credit evaluation and account monitoring procedures. The Company performs ongoing credit evaluations of its customers and establishes an allowance for doubtful accounts on a specific basis. Allowance for doubtful accounts amounted to \$ 374 and \$ 253 as of December 31, 2010 and 2009, respectively.

The Company has no significant off balance sheet concentration of credit risk, except for hedging arrangements to cover the currency exposure of the NIS on identified cash flow items (see also Note 2w)

r. Royalty bearing grants:

Participation grants from the Office of the Chief Scientist of the Ministry of Industry, Trade and Labor in Israel ("OCS") for research and development activity are recognized at the time the Company is entitled to such grants on the basis of the costs incurred and included as a deduction of research and development costs. Research and development grants recognized amounted to \$ 2,774, \$ 2,440 and \$ 2,671 in 2010, 2009 and 2008, respectively.

The Company is obligated to pay royalties to the OCS calculated at the rate of 3%-3.5% of sales of the products developed with the OCS's participation up to 300% of the grants received linked to the U.S. dollar bearing annual interest at a rate of LIBOR. The Company's obligation to pay these royalties is contingent upon actual consolidated sales of our products and no payment is required if no sales are made. As of December 31, 2010, the Company had an outstanding contingent obligation to pay royalties in the amount of \$11.7 million.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

U.S. dollars in thousands, except share and per share data

NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES (CONT.)

s. Income taxes:

The Company accounts for income taxes in accordance with Accounting Standards Codification No. 740, "Income Taxes" ("ASC No. 740"). ASC No. 740 prescribes the use of the liability method, whereby deferred tax asset and liability account balances are determined based on differences between financial reporting and tax bases of assets and liabilities and are measured using the enacted tax rates and laws that will be in effect when the differences are expected to reverse. The Company provides a valuation allowance, if necessary, to reduce deferred tax assets to their estimated realizable value if it is more likely than not that some portion or all of the deferred tax assets will not be realized.

ASC No. 740 contains a two-step approach to recognizing and measuring a liability for uncertain tax positions. The first step is to evaluate the tax position taken or expected to be taken in a tax return by determining if the weight of available evidence indicates that it is more likely than not that, on an evaluation of the technical merits, the tax position will be sustained on audit, including resolution of any related appeals or litigation processes. The second step is to measure the tax benefit as the largest amount that is more than 50% likely to be realized upon ultimate settlement.

t. Basic and diluted net loss per share:

The Company accounts for earnings per share based on Accounting Standards Codification No. 260, "Earnings Per Share" ("ASC No. 260"). Basic earnings per share are calculated using the weighted average number of shares outstanding during the period. Diluted earnings per share is computed on the basis of the weighted average number of shares outstanding and the effect of dilutive potential shares of Ordinary shares considered outstanding during the period.

For the years ended December 31, 2010, 2009 and 2008, all outstanding options and warrants have been excluded from the calculation of the diluted loss per share since their effect was anti-dilutive.

u. Comprehensive income (loss):

The Company accounts for comprehensive income (loss) in accordance with Accounting Standards Codification No. 220, "Comprehensive Income" ("ASC No. 220"). This statement establishes standards for the reporting and display of comprehensive income (loss) and its components in a full set of general purpose financial statements. Comprehensive income (loss) generally represents all changes in shareholders' equity during the period except those resulting from investments by, or distributions to shareholders.

The Company determined that its items of comprehensive income (loss) relate to unrealized gains and losses on hedging derivative instruments and unrealized gains and losses on available-for-sale marketable securities.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

U.S. dollars in thousands, except share and per share data

NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES (CONT.)

v. Fair value of financial instruments:

The Company measures its cash and cash equivalents, marketable securities, derivative instruments, restricted cash and deposits, short-term bank deposits, trade receivables, other receivables, trade payables and other payables at fair value.

Fair value is an exit price, representing the amount that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants. As such, fair value is a market-based measurement that should be determined based on assumptions that

market participants would use in pricing an asset or a liability. A three-tier value hierarchy, which prioritizes the inputs used in the valuation methodologies in measuring fair value:

Level 1 - Observable inputs that reflect quoted prices (unadjusted) for identical assets or liabilities in active markets.

Level 2 - Include other inputs that are directly or indirectly observable in the marketplace, other than quoted prices included in Level 1, such as quoted prices for similar assets or liabilities in active markets, quoted prices for identical or similar assets or liabilities in markets with insufficient volume or infrequent transactions, or other inputs that are observable (model-derived valuations in which significant inputs are observable), or can be derived principally from or corroborated by observable market data; and

Level 3 - Unobservable inputs which are supported by little or no market activity.

The Company categorized each of its fair value measurements in one of those three levels of hierarchy. The fair value hierarchy also requires an entity to maximize the use of observable inputs and minimize the use of unobservable inputs when measuring fair value.

w. Derivatives and hedging:

The Company accounts for derivatives and hedging based on Accounting Standards Codification No. 815, "Derivatives and Hedging" ("ASC No. 815").

The Company accounts for its derivative instruments as either assets or liabilities and carries them at fair value. Derivative instruments that are not designated and qualified as hedging instruments must be adjusted to fair value through earnings.

For derivative instruments that hedge the exposure to variability in expected future cash flows that are designated as cash flow hedges, the effective portion of the gain or loss on the derivative instrument is reported as a component of accumulated other comprehensive income (loss) in shareholders' equity and reclassified into earnings in the same period or periods during which the hedged transaction affects earnings. The ineffective portion of the gain or loss on the derivative instrument is recognized in current earnings. To receive hedge accounting treatment, cash flow hedges must be highly effective in offsetting changes to expected future cash flows on hedged transactions.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

U.S. dollars in thousands, except share and per share data

NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES (CONT.)

x. Recently issued accounting standards

In April 2010, the Financial Accounting Standards Board, or FASB, issued Accounting Standards Update No. 2010-17, Topic 605 — Revenue Recognition – Milestone Method (“ASU 2010-17”), which provides guidance on defining a milestone and determining when it may be appropriate to apply the milestone method of revenue recognition for research or development transactions. The amendments in ASU 2010-17 are effective on a prospective basis for milestones achieved in fiscal years, and interim periods within those years, beginning on or after June 15, 2010. Early adoption is permitted; however, if a company elects to early adopt, the amendment must be applied retrospectively from the beginning of the year of adoption. The Company’s adoption of ASU 2010-17 didn't have an impact on the Company’s condensed consolidated financial statements.

In September 2009, the FASB reached a consensus on Accounting Standards Update 2009-13, Revenue Recognition (Topic 605) — Multiple-Deliverable Revenue Arrangements (“ASU 2009-13”) and Accounting Standards Update 2009-14, Software (Topic 985) — Certain Revenue Arrangements That Include Software Elements (“ASU 2009-14”). ASU 2009-13 modifies the requirements that must be met for an entity to recognize revenue from the sale of a delivered item that is part of a multiple-element arrangement when other items have not yet been delivered. ASU 2009-13 establishes a selling price hierarchy that allows for the use of an estimated selling price to determine the allocation of arrangement consideration to a deliverable in a multiple element arrangement where neither VSOE nor third-party evidence, or TPE, is available for that deliverable. In the absence of VSOE or TPE of the standalone selling price for one or more delivered or undelivered elements in a multiple-element arrangement, entities are required to estimate the selling prices of those elements. Overall arrangement consideration is allocated to each element (both delivered and undelivered items) based on their relative selling prices, regardless of whether those selling prices are evidenced by VSOE or TPE or are based on the entity’s estimated selling price. The residual method of allocating arrangement consideration has been eliminated.

The amendments in ASU 2009-13 and ASU 2009-14 are effective for fiscal years, and interim periods within those years, beginning of their first fiscal year beginning on or after 15 June 2010. Entities may elect to adopt this amendment through either prospective application for revenue arrangements entered into, or materially modified, after the effective date or through retrospective application to all revenue arrangements for all periods presented. Early adoption is permitted;

ASU 2009-14 modifies the software revenue recognition guidance to exclude from its scope tangible products that contain both software and non-software components that function together to deliver a product’s essential functionality.

However, an entity must select the same transition method and same period for the adoption of both ASU 2009-13 and ASU 2009-14.

The Company adopted ASU 2009-13 and ASU 2009-14 as of January 1, 2011. Therefore, the Company will not account for its products sales following the adoption of ASU 2009-14 in accordance with ASC No. 985-605. The Company is currently evaluating the impact of the adoption of ASU 2009-13 and ASU 2009-14 on its consolidated financial statements.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

U.S. dollars in thousands, except share and per share data

NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES (CONT.)

- x. Recently issued accounting standards (Cont.):

In January 2010, the FASB issued Accounting Standards Update No. 2010-06, Topic 820 — Improving Disclosures about Fair Value Measurements (“ASU 2010-06”), which provides additional fair value measurement disclosures and clarifies certain existing disclosure requirements. Except for the requirement to disclose purchases, sales, issuances and settlements of Level 3 measurements on a gross basis, the disclosure and clarification requirements are effective for interim and annual reporting periods beginning after December 15, 2009. The requirement to separately disclose purchases, sales, issuances and settlements of recurring Level 3 measurements on a gross basis is effective for fiscal years beginning after December 15, 2010 and for interim periods within those fiscal years. ASU 2010-06 relates to disclosure requirements only and as such does not impact the Company’s consolidated financial statements

The Company may elect to adopt the update prospectively, to new or materially modified arrangements beginning on the adoption date, or retrospectively, for all periods presented.

NOTE 3:- ACQUISITIONS

On January 8, 2008, the Company completed an acquisition of the business of Esphion Limited, (“Esphion”) a New Zealand based, developer of network protection solutions for carriers and internet service providers. The total consideration including direct transaction costs for the acquisition was approximately \$ 3,802, plus potential earn-outs based on performance milestones amounting to a maximum of an additional \$ 2,000 payable through December 31, 2008.

As of December 31, 2008, Esphion met certain milestones in accordance with the acquisition agreement. Consequently, out of the maximum additional \$ 2,000, the Company paid additional \$ 186 and increased its goodwill accordingly.

The total purchase price of Esphion was composed of the following:

Cash paid	\$ 3,500
Acquisition related transaction costs	302
Total	<u>\$ 3,802</u>

Acquisition related transaction costs include investment banking fees, legal and accounting fees and other external costs directly related to the acquisition.

Purchase price allocation:

Under business combination accounting, the total purchase price was allocated to Esphion's net tangible and identifiable intangible assets based on their estimated fair values as set forth below. The excess of the purchase price over the net tangible and identifiable intangible assets was recorded as goodwill.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

U.S. dollars in thousands, except share and per share data

NOTE 3:- ACQUISITIONS (CONT.)

Tangible assets:	
Current assets	\$ 61
Property and equipment	<u>49</u>
Net tangible assets	110
Intangible assets:	
Core technology	726
In process research and development	244
Goodwill	<u>2,722</u>
Total assets acquired	<u>\$ 3,802</u>

In performing the purchase price allocation, the Company considered, among other factors, the intention for future use of acquired assets, analyses of historical financial performance and estimates of future revenues to be generated from the Service Protector. The fair value of the intangible assets was based on the Company's management estimates and assumptions that were utilized via a valuation of a third party valuation firm, using the income approach.

Core technology represents a combination of Espion processes and patents related to the design and development of the Service Protector. This proprietary know-how can be leveraged to develop new technology and improve the Company's products (see also Note 8a).

The Company expensed in-process research and development ("IPR&D") in the amount of \$ 244 upon acquisition as it represents incomplete Espion research and development projects that had not reached technological feasibility and had no alternative future use as of the date of the acquisition. The value assigned to IPR&D was determined by considering the importance of the project to the Company's overall development plan, estimating costs to develop the purchased IPR&D into commercially viable products, estimating the resulting net cash flow from the project when completed and discounting the net cash flow to its present value based on the percentage of completion of the IPR&D projects.

Pro forma information in accordance with Accounting Standards Codification No. 805 ("Business Combinations" ("ASC No. 805")) has not been provided, since Espion's results for 2008 and 2007, were not material in relation to total consolidated revenues and net loss.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

U.S. dollars in thousands, except share and per share data

NOTE 4:- AVAILABLE-FOR-SALE MARKETABLE SECURITIES

The following is a summary of available-for-sale marketable securities:

	December 31, 2010				December 31, 2009			
	Amortized cost	Gross unrealized gain	Gross unrealized loss	Fair value	Amortized cost	Gross unrealized gain	Gross unrealized loss	Fair value
Available-for-sale - matures within one year:								
Governmental debentures	\$ 1,022	\$ 1	\$ --	\$ 1,023	\$ --	\$ --	\$ --	\$ --
Federal Home Loan Bank	807	--	--	807	--	--	--	--
Corporate debentures	210	3	--	213	--	--	--	--
	<u>2,039</u>	<u>4</u>	<u>--</u>	<u>2,043</u>	<u>--</u>	<u>--</u>	<u>--</u>	<u>--</u>
Available-for-sale - matures after one year through three years:								
Governmental debentures	8,418	1	(4)	8,415	--	--	--	--
Federal Home Loan Bank	201	--	(1)	200	--	--	--	--
Corporate debentures	4,896	--	(23)	4,873	--	--	--	--
	<u>13,515</u>	<u>1</u>	<u>(28)</u>	<u>13,488</u>	<u>--</u>	<u>--</u>	<u>--</u>	<u>--</u>
Available-for-sale - matures after three years:								
Auction Rate Securities (ARS)	--	--	--	--	12,283	2,207	--	14,490
	<u>\$ 15,554</u>	<u>\$ 5</u>	<u>\$ (28)</u>	<u>\$ 15,531</u>	<u>\$ 12,283</u>	<u>\$ 2,207</u>	<u>\$ --</u>	<u>\$ 14,490</u>
Reclassification of certain securities to long term				--				14,490
				<u>\$ 15,531</u>				<u>\$ --</u>

The balance, as of December 31, 2009, was comprised of ARS with contractual maturities of more than one year, which suffer from failed auctions since September 2007. As a result of the auction failures, these ARS do not have a readily determinable market value. In 2009, as there was insufficient observable market information available to determine the fair value of the ARS and the portion of the impairment that relates to credit loss of these securities, the fair value was determined using an independent third party valuator. The fair value was based on a trinomial discount model employing assumptions that market participants would use in their estimates of fair value.

The assumptions included, among others, the following: the underlying structure of the security, the financial standing of the issuer, stated maturities, estimates of the probability of the issue being called at par prior to final maturity, estimates of the probability of defaults and recoveries, auctions failure and successful auction or repurchase at par for each period, expected changes in interest rates paid on the securities, interest rates paid on similar instruments. Finally, the present value of the future principal and interest payments was discounted at rates considered to reflect current market conditions for each security.

Based on the Company's consideration of these factors, the Company recognized in 2009 an other-than-temporary net impairment in a total amount of \$ 3,036, related to ARS, and the cumulative impairment was \$15,217.

Since there was an uncertainty about the Company's ability to liquidate the ARS in a short time, the entire amount of the ARS was presented as non-current assets on the Company's balance sheet, as of December 31, 2009.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

U.S. dollars in thousands, except share and per share data

NOTE 4:- AVAILABLE-FOR-SALE MARKETABLE SECURITIES (CONT.)

To the extent that the net present value of the projected cash flows is less than the amortized cost of the security, the difference is considered a credit loss and is recorded through earnings. The inputs on the future performance of the underlying assets used in the cash flow models include prepayments defaults and loss severity assumptions. The Company adopted ASC No. 320 in 2009, and reclassified the \$ 7,681 non-credit related portion of other-than-temporary impairment losses recognized in prior period earnings as a cumulative effect adjustment that decreased accumulated deficit and decreased accumulated other comprehensive income.

The following table presents a cumulative roll forward of the amount related to credit losses recognized in earnings as of December 31, 2009:

	<u>Credit loss</u>
Balance as of April 1, 2009	\$ 6,058
Additional credit loss on debt securities for which other-than-temporary impairment was previously recognized	1,431
Reduction related to cash flow from expected to be collected	<u>(809)</u>
Balance as of December 31, 2009	<u>\$ 6,680</u>

During 2010, the Company had sold its entire ARS portfolio, and reclassified the loss recorded in accordance with ASC No. 320 in the accumulated other comprehensive loss in the amount of \$5,474 to financing expenses net and recognized an additional loss of \$2,238.

NOTE 5:- FAIR VALUE MEASUREMENTS:

In accordance with ASC No. 820, the Company measures its cash equivalents, restricted cash and deposit, short-term bank deposits, marketable securities and foreign currency derivative instruments at fair value. Cash equivalents, restricted deposit and short-term bank deposits, except for investments in marketable securities are classified within Level 1 or Level 2. This is because these assets are valued using quoted market prices or alternative pricing sources and models utilizing market observable inputs. Investments in marketable securities are classified within Level 3 because they are valued using valuation techniques. Some of the inputs to these models are unobservable in the market and are significant.

The Company values the Level 3 investments based on an externally developed valuation using discounted cash flow model, whose inputs include interest rate curves, credit spreads, bond prices, volatilities and illiquidity considerations. Unobservable inputs used in these models are significant to the fair value of the investments.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

U.S. dollars in thousands, except share and per share data

NOTE 5:- FAIR VALUE MEASUREMENTS (CONT.):

The Company's financial assets measured at fair value on a recurring basis, excluding accrued interest components; consisted of the following types of instruments as of December 31, 2010 and 2009, respectively:

	As of December 31, 2010			
	Fair value measurements using input type			
	Level 1	Level 2	Level 3	Total
Treasury Bills	\$ 12,548	\$ -	\$ -	\$ 12,548
Money market funds	2,426	-	-	2,426
Restricted deposit	-	60	-	60
Available-for-sale marketable securities	-	15,531	-	15,531
Foreign currency derivative contracts	-	457	-	457
Total financial assets	\$ 14,974	\$ 16,048	\$ -	\$ 31,022

	As of December 31, 2009			
	Fair value measurements using input type			
	Level 1	Level 2	Level 3	Total
Money market funds	\$ 15,358	\$ -	\$ -	\$ 15,358
Restricted deposit	-	60	-	60
Short-term deposits	-	1,264	-	1,264
Auction-rate securities	-	-	14,490	14,490
Foreign currency derivative contracts	-	612	-	612
Total financial assets	\$ 15,358	\$ 1,936	\$ 14,490	\$ 31,784

The following table presents the changes in Level 3 instruments measured on a recurring basis for the years ended December 31, 2010 and 2009. The Company's Level 3 instruments consist of marketable securities classified as available-for-sale.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

U.S. dollars in thousands, except share and per share data

NOTE 5:- FAIR VALUE MEASUREMENTS (CONT.):

Fair value measurements using significant unobservable inputs (Level 3):

	<u>Marketable Securities</u>
Balance at January 1, 2009	\$ 15,319
Total gains and losses (realized and unrealized)	-
Included in financial and other expenses, net	(3,036)
Included in other comprehensive loss	2,207
Purchases and sales	-
Balance at December 31, 2009	14,490
Total gains and losses (realized and unrealized)	-
Included in financial and other expenses, net	(2,238)
Included in other comprehensive loss	-
Purchases and sales	(12,252)
Balance at December 31, 2010	<u>\$ -</u>

NOTE 6:- DERIVATIVE INSTRUMENTS

The Company enters into hedge transactions with a major financial institution, using derivative instruments, primarily forward contracts and options to purchase and sell foreign currencies, in order to reduce the net currency exposure associated with anticipated expenses (primarily salaries and related expenses) in currencies other than U.S. dollar, and forecasted revenues denominated in Euro. The net losses recognized in "financial and other expenses, net" during the year ended December 31, 2010, 2009 and 2008 were \$ 471, \$ 52 and \$ 0, respectively.

The Company currently hedges such future exposures for a maximum period of one year. However, the Company may choose not to hedge certain foreign currency exchange exposures for a variety of reasons, including but not limited to immateriality, accounting considerations and the prohibitive economic cost of hedging particular exposures. There can be no assurance the hedges will offset more than a portion of the financial impact resulting from movements in foreign currency exchange rates.

The Company records all derivatives on the consolidated balance sheets at fair value in accordance with ASC No. 820 at level 2. The effective portions of cash flow hedges are recorded in other comprehensive income until the hedged item is recognized in earnings. The ineffective portions of cash flow hedges are adjusted to fair value through earnings in financial other income or expense. The Company does not enter into derivative transactions for trading purposes.

The Company had a net unrealized gain associated with cash flow hedges of \$ 457 and \$ 612 recorded in other comprehensive income as of December 31, 2010 and 2009, respectively.

As of December 31, 2010 and 2009, the Company had outstanding forward contracts in the amount of \$ 13,868 and \$15,443, respectively.

As of December 31, 2010 and 2009, the Company had outstanding foreign exchange option contract in the amount of \$ 6,411 and \$ 690, respectively.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

U.S. dollars in thousands, except share and per share data

NOTE 6:- DERIVATIVE INSTRUMENTS (CONT.)

The fair value of the open foreign exchange contracts recorded by the Company on its consolidated balance sheets as of December 31, 2010 and 2009, as an asset is as follows:

Foreign exchange forward and options contracts	Balance Sheet	December 31, 2010	December 31, 2009
Fair Value of foreign exchange option contracts	Other receivables and prepaid expenses	\$ 167	\$ 24
Fair value of foreign exchange forward contracts	Other receivables and prepaid expenses	290	588
Total derivatives designated as hedging instrument		<u>\$ 457</u>	<u>\$ 612</u>
Total derivatives not designated as hedging instrument	Other receivables and prepaid expenses (Other payables and accrued expenses)	<u>\$ (45)</u>	<u>\$ 36</u>

Gain or loss on the derivative instruments, which partially offset the foreign currency impact from the underlying exposures, reclassified from other comprehensive income to operating expenses for the year ended December 31, 2010 and 2009 were \$841, and \$383, respectively. The ineffective portion of the change in fair value of a cash flow hedge for the year ended December 31, 2010, was not material.

Non-Designated Hedges

The Company also uses foreign currency forward contracts to mitigate variability in gains and losses generated from the re-measurement of certain monetary assets and liabilities denominated in foreign currencies. These derivatives do not qualify for special hedge accounting treatment. These derivatives are carried at fair value with changes recorded in interest and other income, net. Changes in the fair value of these derivatives are largely offset by re-measurement of the underlying assets and liabilities. Cash flows from such derivatives are classified as operating activities. The derivatives have maturities of approximately twelve months.

NOTE 7:- OTHER ACCOUNTS RECEIVABLE AND PREPAID EXPENSES

	December 31,	
	2010	2009
Prepaid expenses	\$ 1,482	\$ 510
Short-term lease deposits	195	173
Other receivable from insurance carrier in regard of class action (see Note 12)	1,300	1,300
Government authorities	1,056	428
Grants receivable from the OCS	272	337
Foreign currency derivative contracts	457	648
Others	196	222
	<u>\$ 4,958</u>	<u>\$ 3,618</u>

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

U.S. dollars in thousands, except share and per share data

NOTE 8:- INVENTORIES

	December 31,	
	2010	2009
Raw materials	\$ 1,071	\$ 578
Finished products	9,759	4,468
	<u>\$ 10,830</u>	<u>\$ 5,046</u>

For the year ended December 31, 2010 and 2009 the Finished products line item above includes the cost of goods sold for which revenue was not yet recognized, in the amount of approximately \$4,622 and \$711, respectively.

NOTE 9:- PROPERTY AND EQUIPMENT

	December 31,	
	2010	2009
Cost:		
Lab equipment	\$ 9,270	\$ 8,249
Computers and peripheral equipment	6,535	5,663
Office furniture and equipment	419	413
Leasehold improvements	527	497
	<u>16,751</u>	<u>14,822</u>
Accumulated depreciation:		
Lab equipment	6,466	5,136
Computers and peripheral equipment	4,549	3,563
Office furniture and equipment	213	181
Leasehold improvements	330	268
	<u>11,558</u>	<u>9,148</u>
Depreciated cost	<u>\$ 5,193</u>	<u>\$ 5,674</u>

Depreciation expenses for the years ended December 31, 2010, 2009 and 2008, were \$ 2,577, \$ 2,468 and \$ 1,988, respectively.

The Company recorded during the year ended December 31, 2009 a disposal of property and equipment, which ceased to be used in a total amount of \$ 619, and related accumulated depreciation in the amount of \$ 234. The disposal of such equipment resulted in a loss of \$385 that was recorded in the consolidated statement of operations.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

U.S. dollars in thousands, except share and per share data

NOTE 10:- INTANGIBLE ASSETS, NET

- a. The following table shows the Company's intangible assets for the periods presented:

	December 31,	
	2010	2009
Cost:		
Core technology (1)	\$ 726	\$ 726
Accumulated amortization	358	235
Amortized cost	<u>\$ 368</u>	<u>\$ 491</u>

- (1) Core technology was recorded in 2008 following the acquisition of the tangible and the intangible assets of Espion. The Company amortizes the intangible assets using the straight-line method over a period of six years, which constitutes the number of years that approximate the pattern in which the economic benefits of the intangible assets will be consumed (see also Note 3).
- b. Amortization expenses for the years ended December 31, 2010, 2009 and 2008, were \$ 123, \$ 116 and \$ 119, respectively.
- c. Estimated amortization expenses for the years ending:

Year ending December 31,	
2011	\$ 123
2012	123
2013	<u>122</u>
Total	<u>\$ 368</u>

NOTE 11:- OTHER PAYABLES AND ACCRUED EXPENSES

	December 31,	
	2010	2009
Accrued expenses	\$ 1,581	\$ 2,082
Other payable in regard of class action (see Note 12)	1,300	1,300
Accrued royalties to the OCS	1,157	848
Others	331	352
	<u>\$ 4,369</u>	<u>\$ 4,582</u>

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

U.S. dollars in thousands, except share and per share data

NOTE 12:- COMMITMENTS AND CONTINGENT LIABILITIES

a. Royalties:

The Company received research and development grants from the OCS.

The Company is participating in programs sponsored by the Israeli Government for the support of research and development activities. Currently, the Company is obligated to pay royalties to the OCS, amounting to 3.5% of the sales of the sponsored products, up to 100% of the grants received, linked to the U.S. dollar and for grants received after January 1, 1999 also bearing interest at the rate of LIBOR. The obligation to pay these royalties is contingent upon actual sales of products of the Company and in the absence of such sales no payment is required.

As of December 31, 2010, the Company has paid and accrued royalties to the OCS in the amount of \$ 8,994, which was recorded to cost of revenues.

b. Lease commitments:

In February 2006, the Company signed an agreement to rent offices for a period of seven years, starting July 2006. The rental expenses are \$ 39 per month and a management fee of costs plus 15% of the expenses incurred by the building management company as stipulated in the lease agreement.

The U.S. subsidiary has an operating lease for office facilities in Woburn, Massachusetts. The lease expires on August 31, 2014. The Company's subsidiaries maintain smaller offices in China, Singapore, Japan, New Zealand and various locations in Europe.

In addition, the Company has operating lease agreements for its motor vehicles, which terminate in 2011 through 2013

Operating leases (offices and motor vehicles) expenses for the years ended December 31, 2010, 2009 and 2008, were \$ 1,676, \$ 1,981 and \$ 2,667, respectively.

As of December 31, 2010, the aggregate future minimum lease obligations (offices and motor vehicles) under non-cancelable operating leases agreements were as follows:

Year ended December 31,	
2011	\$ 1,217
2012	977
2013	539
2014	<u>80</u>
Total	<u>\$ 2,813</u>

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

U.S. dollars in thousands, except share and per share data

NOTE 12:- COMMITMENTS AND CONTINGENT LIABILITIES (CONT.)

c. Lawsuit:

On May 1, 2007, a securities class action complaint, *Brickman Investment Inc. v. Allot Communications Ltd. et al.*, was filed in the United States District Court for the Southern District of New York. At least three substantially similar complaints were filed in the same court after the original action was filed. We and certain of our directors and officers are named as defendants. The securities class action complaints allege that the defendants violated Sections 11 and 15 of the Securities Act of 1933 by making false and misleading statements and omissions in our registration statement for our initial public offering in November 2006. The claims are purportedly brought on behalf of persons who purchased our stock pursuant to and/or traceable to the initial public offering on or about November 15, 2006 through April 2, 2007. The plaintiffs seek unspecified compensatory damages against the defendants, as well as attorney's fees and costs. Motions for consolidation and for appointment of lead plaintiff were filed on July 2, 2007 and were decided on March 27, 2008, with an order granting consolidation and appointing co-lead plaintiffs. The Consolidated Amended Complaint was served on June 9, 2008. The defendants moved to dismiss the Consolidated Amended Complaint on August 8, 2008. While the defendants' motion to dismiss was still pending, the parties reached on March 31, 2010 an agreement in principle to settle this litigation. Pursuant to the terms of the agreement, the Company will pay to the plaintiffs, for the benefit of the class members, \$1.3 million in cash, which amount is to be funded by the Company's insurance carrier. The settlement contemplated therein is conditional upon approval by the court and other contingencies. There is no assurance that final court approval will be obtained. If such approval is not obtained, the parties to this litigation may attempt to reach agreement on alternative settlement terms or resume the litigation. The Company has recorded a liability in its financial statements for the proposed amount of the settlement. In addition, because the insurance carrier has agreed to pay the entire settlement amount and recovery from the insurance carrier is probable, a receivable has also been recorded for the same amount. Accordingly, there is no impact to the Company's statements of operations or cash flows because the amounts of the settlement and the insurance recovery fully offset each other (See Note 7 and 11).

d. Major Subcontractor:

The Company currently depends on one subcontractor to manufacture and provide hardware warranty support for its traffic management systems. If the subcontractor experiences delays, disruptions, quality control problems or a loss in capacity, shipments of products may be delayed and the Company's ability to deliver products could be materially adversely affected. Certain hardware components for the Company's products come from single or limited sources, and the Company could lose sales if these sources fail to satisfy its supply requirements. In the event that the Company terminates its business connection with the subcontractor, it will have to compensate the subcontractor for certain inventory costs, as specified in the agreement with the subcontractor.

NOTE 13:- SHAREHOLDERS' EQUITY

a. Company's shares

As of December 31, 2010, the Company's authorized share capital consists of NIS 20,000,000 divided into 200,000,000 Ordinary Shares, par value NIS 0.1 per share. Ordinary Shares confer on their holders the right to receive notice to participate and vote in general meetings of the Company, the right to a share in the excess of assets upon liquidation of the Company, and the right to receive dividends, if declared.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

U.S. dollars in thousands, except share and per share data

NOTE 13:- SHAREHOLDERS' EQUITY (CONT.)

b. Warrants

During January 1998, the Company granted, to a Founder and a member of the Board of Directors who also served as Chief Executive Officer at the time of the grant 246,479 warrants to purchase ordinary shares at a purchase price of \$2.43 per share. The underlying shares were issued and held in trust for the benefit of the Founder, pending his payment of the full purchase price of approximately \$ 600. During November 2010, the warrants were exercised through a cashless exercise, into 165,200 Ordinary shares of the Company. For the purposes of calculating shareholders equity as of December 31, 2009, the Company did not consider such shares to be outstanding because neither the Founder nor the trustee had voting or economic rights with respect to such shares.

c. Stock option plan:

A summary of the Company's stock option activity, pertaining to its option plans for employees and non-employees, and related information is as follows:

	Year ended December 31,					
	2010		2009		2008	
	Number of shares upon exercise	Weighted average exercise price	Number of shares upon exercise	Weighted average exercise price	Number of shares upon exercise	Weighted average exercise price
Outstanding at beginning of year	4,081,683	\$ 3.07	4,069,505	\$ 3.54	3,221,494	\$ 4.42
Granted	906,850	\$ 5.36	1,055,497	\$ 3.05	1,299,150*)	\$ 2.46
Forfeited	(316,612)	\$ 3.89	(713,374)	\$ 6.46	(392,271)	\$ 7.49
Exercised	(1,244,051)	\$ 2.50	(329,945)	\$ 1.47	(58,868)	\$ 1.53
Outstanding at end of year	<u>3,427,870</u>	<u>\$ 3.81</u>	<u>4,081,683</u>	<u>\$ 3.07</u>	<u>4,069,505</u>	<u>\$ 3.54</u>
Exercisable at end of year	<u>1,638,086</u>	<u>\$ 3.46</u>	<u>2,226,413</u>	<u>\$ 3.12</u>	<u>2,050,911</u>	<u>\$ 3.34</u>
Vested and Expected to Vest	<u>3,019,542</u>	<u>\$ 3.7</u>	<u>2,143,854</u>	<u>\$ 3.33</u>	<u>1,611,697</u>	<u>\$ 3.38</u>

*) Including 11,800 restricted stock units ("RSUs") granted during 2008.

The aggregate intrinsic value represents the total intrinsic value (the difference between the Company's closing stock price on the last trading day of the fiscal year 2010 and the exercise price, multiplied by the number of in-the-money options) that would have been received by the option holders had all option holders exercised their options on December 31, 2010. This amount may change based on the fair market value of the Company's stock. The total intrinsic value of options outstanding at December 31, 2010, was \$ 26,902. The total intrinsic value of exercisable options at December 31, 2010 was approximately \$ 13,401. The total intrinsic value of options vested and expected to vest at December 31, 2010 was approximately \$ 23,981.

The total intrinsic value of options exercised during the year ended December 31, 2010 was approximately \$ 11,388. The number of options vested during the year ended December 31, 2010 was 657,411. The weighted-average remaining contractual life of the outstanding options as of December 31, 2010 is 7.67 years. The weighted-average remaining contractual life of exercisable options as of December 31, 2010, is 6.44 years. As of December 31, 2010, \$ 3,463 unrecognized compensation cost related to stock options is expected to be recognized over a period of 4 years with weighted average period of 1.5 years.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

U.S. dollars in thousands, except share and per share data

NOTE 13:- SHAREHOLDERS' EQUITY (CONT.)

c. Stock option plan (Cont.):

The options outstanding as of December 31, 2010, have been classified by exercise price, as follows:

<u>Exercise price</u>	<u>Shares upon exercise of options outstanding as of December 31, 2010</u>	<u>Weighted average remaining contractual life Years</u>	<u>Shares upon exercise of options exercisable as of December 31, 2010</u>
\$ 9.7-11.34	51,598	6.11	51,598
\$ 7.25-9.25	347,900	9.43	37,931
\$ 5.7-6.59	41,075	6.60	37,549
\$ 4.02-5.25	713,150	8.86	118,185
\$ 3.00-4.00	1,125,060	6.78	785,926
\$ 1.92-2.97	1,024,118	7.42	550,769
\$ 1.205-1.56	52,531	5.74	35,218
\$ 0.009-0.03	72,438	7.83	20,910
	<u>3,427,870</u>		<u>1,638,086</u>

The Company has three option plans under which outstanding options as of December 31, 2010, are as follows: (i) under the 1997 option plan, the outstanding options are exercisable for 3,549 Ordinary shares; (ii) under the 2003 option plan, the outstanding options are exercisable for 764,253 Ordinary shares, and (iii) under the 2006 option plan, the outstanding options and RSUs are exercisable for 2,658,381 Ordinary shares.

Under the terms of the above option plans, options may be granted to employees, officers, directors and various service providers of the Company and its subsidiaries. The options generally become exercisable quarterly over a four-year period, commencing one year after date of the grant, subject to the continued employment of the employee. The options generally expire no later than ten years from the date of the grant. The exercise price of the options granted under the plans may not be less than the nominal value of the shares into which such options are exercised, any options, which are forfeited or cancelled before expiration, become available for future grants. As of December 31, 2010, 196,002 Ordinary shares are available for future issuance under the option plan.

In addition to granting stock options, the Company granted in 2008 RSUs under the 2006 Plan. RSUs vest over a four year period subject to the continued employment of the employee. RSUs that are cancelled or forfeited become available for future grants.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

U.S. dollars in thousands, except share and per share data

NOTE 14:- TAXES ON INCOME

- a. Income Tax (Inflationary Adjustments) Law, 1985:

According to the law, until 2007, the results for tax purposes were adjusted for the changes in the Israeli consumer price index ("Israeli CPI"). In February 2008, the "Knesset" (Israeli parliament) passed an amendment to the Income Tax (Inflationary Adjustments) Law, 1985, which limits the scope of the law starting 2008 and thereafter. Starting 2008, the results for tax purposes are measured in nominal values, excluding certain adjustments for changes in the Israeli CPI carried out in the period up to December 31, 2007. The amendment to the law includes, inter alia, the elimination of the inflationary additions and deductions and the additional deduction for depreciation starting 2008.

- b. Corporate tax rates:

Taxable income of Israeli companies is subject to tax at the rate of 27% in 2008, 26% in 2009, and 25% in 2010 and thereafter. In July 2009, Israel's Parliament (the Knesset) passed the Economic Efficiency Law (Amended Legislation for Implementing the Economic Plan for 2009 and 2010), 2009, which prescribes, among other things, an additional gradual reduction in the Israeli corporate tax rate and real capital gains tax rate starting from 2011 to the following tax rates: 2011 - 24%, 2012 - 23%, 2013 - 22%, 2014 - 21%, 2015 - 20%, 2016 and thereafter - 18%. However, the effective tax rate payable by a company which derives income from an approved enterprise may be considerably lower (see also Note 12c).

- c. Tax benefits under Israel's law for the Encouragement of Capital Investments, 1959 ("the Law"):

In 1998, the production facilities of the Company related to its computational technologies were granted the status of an "Approved Enterprise" under the Law. In 2004, expansion program was granted the status of "Approved Enterprise". According to the provisions of the Law, the Company has elected the alternative package of benefits - and has waived Government grants in return for tax benefits.

According to the provisions of the Law, the Company's income is tax-exempt for a period of two years commencing with the year it first earns taxable income, and subject to corporate taxes at the reduced rate of 10% to 25%, for an additional period of five to eight years depending upon the level of foreign ownership of the Company. The benefit period of tax benefit has not yet commenced, since the Company has not yet reported taxable income.

The period of tax benefits, detailed above, is limited to the earlier of 12 years from the commencement of production, or 14 years from the approval date, (the year's limitation does not apply to the exemption period).

The Law was significantly amended effective April 1, 2005 ("the Amendment"). The Amendment includes revisions to the criteria for investments qualified to receive tax benefits as a Beneficiary Enterprise and among other things, simplifies the approval process. The Amendment applies to new investment programs. Therefore, investment programs commencing after December 31, 2004, do not affect the approved programs of the Company.

In addition, the Law provides that terms and benefits included in any letter of approval already granted will remain subject to the provisions of the Law as they were on the date of such approval. Therefore the Company's existing Approved Enterprise will generally not be subject to the provisions of the Amendment.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

U.S. dollars in thousands, except share and per share data

NOTE 14:- TAXES ON INCOME (CONT.)

- c. Tax benefits under Israel's law for the Encouragement of Capital Investments, 1959 ("the Law") (Cont.):

The entitlement to the above benefits is contingent upon the fulfillment of the conditions stipulated in the Law, regulations published there under and the criteria set forth in the specific letters of approval. In the event of failure to comply with these conditions, the benefits may be canceled and the Company may be required to refund the amount of the benefits, in whole or in part, including interest and linked to changes in the Israeli CPI. As of December 31, 2010, management believes that the Company is meeting the aforementioned conditions.

If the Company pays a dividend out of income derived from the Approved and Beneficiary Enterprise during the tax exemption period, it will be subject to corporate tax in respect of the gross amount distributed, including any taxes thereon, at the rate which would have been applicable had it not enjoyed the alternative benefits, generally 10%-25%, depending on the percentage of the Company's Ordinary shares held by foreign shareholders. The dividend recipient is subject to withholding tax at the rate of 15% applicable to dividends from approved enterprises, if the dividend is distributed during the tax exemption period or within twelve years thereafter. The Company currently has no plans to distribute dividends and intends to retain future earnings to finance the development of its business.

Income from sources other than the "Approved and Beneficiary Enterprise" during the benefit period will be subject to tax at the regular corporate tax rate.

During 2010, new legislation amending to the Law was adopted. Under this new legislation, a uniform corporate tax rate will apply to all qualifying income of certain Industrial Companies, as opposed to the current law's incentives, which are limited to income from Approved Enterprises during their benefits period. Under the new law, the uniform tax rate will be 10% in areas in Israel designated as Development Zone A and 15% elsewhere in Israel during 2011-2012, 7% and 12.5%, respectively, in 2013-2014, and 6% and 12%, respectively thereafter. Certain "Special Industrial Companies" that meet certain criteria (somewhat equivalent to the criteria for the Strategic Investment Track noted above) will enjoy further reduced tax rates of 5% in Zone A and 8% elsewhere. The profits of these Industrial Companies will be freely distributable as dividends, subject to a 15% withholding tax (or lower, under an applicable tax treaty).

Under the transition provisions of the new legislation, the Company may decide to irrevocably implement the new law while waiving benefits provided under the current law or to remain subject to the current law. Changing from the current law to the new law is permitted at any time. The Company does not expect the new law to have a material effect on the tax payable on its Israeli operations.

- d. Tax benefits under the law for the Encouragement of Industry (taxes), 1969 ("the Encouragement Law"):

The Encouragement Law, provides several tax benefits for industrial companies. An industrial company is defined as a company resident in Israel, at least 90% of the income of which in a given tax year exclusive of income from specified Government loans, capital gains, interest and dividends, is derived from an industrial enterprise owned by it. An industrial enterprise is defined as an enterprise whose major activity in a given tax year is industrial production activity.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

U.S. dollars in thousands, except share and per share data

NOTE 14:- TAXES ON INCOME (CONT.)

- d. Tax benefits under the law for the Encouragement of Industry (taxes), 1969 ("the Encouragement Law") (Cont.):

Management believes that the Company is currently qualified as an "industrial company" under the Encouragement Law and as such, enjoys tax benefits, including: (1) Deduction of purchase of know-how and patents and/or right to use a patent over an eight-year period; (2) The right to elect, under specified conditions, to file a consolidated tax return with additional related Israeli industrial companies and an industrial holding company; (3) Accelerated depreciation rates on equipment and buildings; and (4) Expenses related to a public offering on the Tel-Aviv Stock and on recognized stock markets outside of Israel, are deductible in equal amounts over three years.

Eligibility for benefits under the Encouragement Law is not subject to receipt of prior approval from any Governmental authority. No assurance can be given that the Israeli tax authorities will agree that the Company qualifies, or, if the Company qualifies, then the Company will continue to qualify as an industrial company or that the benefits described above will be available to the Company in the future.

- e. Pre-tax loss is comprised as follows:

	Year ended December 31,		
	2010	2009	2008
Domestic	\$ (6,637)	\$ (7,558)	\$ (16,525)
Foreign	959	(51)	250
	<u>\$ (5,678)</u>	<u>\$ (7,609)</u>	<u>\$ (16,275)</u>

- f. A reconciliation of the theoretical tax expenses, assuming all income is taxed at the statutory tax rate applicable to the income of the Company and the actual tax expenses is as follows:

	Year ended December 31,		
	2010	2009	2008
Loss before taxes on income	<u>\$ (5,678)</u>	<u>\$ (7,609)</u>	<u>\$ (16,275)</u>
Theoretical tax expense (benefit) computed at the statutory tax rate (25%, 26% and 27% for the years 2010, 2009 and 2008, respectively)	\$ (1,419)	\$ (1,978)	\$ (4,394)
Losses and temporary differences, net in respect of which no deferred taxes were recorded	728	1,738	3,811
Taxes with respect to prior years	35	(189)	(58)
Change in expense associated with tax positions for current year	-	(210)	35
Impairment (recording) of withholding tax asset	(53)	29	74
Non-deductible expenses and other	60	70	265
Non-deductible share-based compensation expenses	499	597	454
Others	234	6	33
Actual tax expenses	<u>\$ 84</u>	<u>\$ 63</u>	<u>\$ 220</u>

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

U.S. dollars in thousands, except share and per share data

NOTE 14:- TAXES ON INCOME (CONT.)

- g. Taxes on income are comprised as follows:

	<u>Year ended December 31,</u>		
	<u>2010</u>	<u>2009</u>	<u>2008</u>
Current taxes	\$ 109	\$ 113	\$ 343
Deferred taxes	(7)	320	(174)
Taxes in respect of previous years	35	(189)	(58)
Change in expense associated with tax positions for current year	-	(210)	35
Impairment (recording) of withholding tax asset	(53)	29	74
	<u>\$ 84</u>	<u>\$ 63</u>	<u>\$ 220</u>

- h. Net operating losses carry forward:

The Company has accumulated losses for tax purposes as of December 31, 2010, in the amount of approximately \$ 43,000, which may be carried forward and offset against taxable income in the future for an indefinite period. In addition, the Company has accumulated capital losses for tax purposes as of December 31, 2010, in the amount of approximately \$21,000, which may be carried forward and offset against taxable capital gains in the future for an indefinite period. The Company expects that during the period in which these tax losses are utilized its income would be substantially tax exempt. Accordingly, there will be no tax benefit available from such losses and no deferred income taxes have been included in these financial statements.

The European subsidiary is subject to French income taxes and has a net operating loss carry forward amounting as of December 31, 2010, to approximately \$ 2,700, which may be carried forward and offset against taxable capital gains in the future for an indefinite period.

- i. Deferred income taxes:

Deferred income taxes reflect the net tax effects of temporary differences between the carrying amounts of assets and liabilities for financial reporting purposes and the amounts used for income tax purposes. Significant components of the Company's deferred income tax are as follows:

	<u>December 31,</u>	
	<u>2010</u>	<u>2009</u>
Deferred tax assets:		
Operating and capital loss carry forward	\$ 13,539	\$ 11,070
Reserves and allowances	2,905	4,639
Deferred tax asset before valuation allowance	16,444	15,709
Valuation allowance	(16,287)	(15,559)
Net deferred tax asset	<u>\$ 157</u>	<u>\$ 150</u>

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

U.S. dollars in thousands, except share and per share data

NOTE 14:- TAXES ON INCOME (CONT.)

j. A reconciliation of the beginning and ending amount of unrecognized tax benefits is as follows:

	December 31,	
	2010	2009
Beginning balance	\$ 75	\$ 285
Increase (decrease) in exposure associated with tax positions for current year	--	(210)
Ending balance	<u>\$ 75</u>	<u>\$ 75</u>

The Company conducts business globally and, as a result, the Company or one or more of its subsidiaries file income tax returns in the U.S. federal jurisdiction and various states and foreign jurisdictions. In the normal course of business, the Company is subject to examination by taxing authorities throughout the world, including such major jurisdictions as Israel, France, and the United States. With few exceptions, the Company is no longer subject to Israeli final tax assessment through the year 2005 and the European and U.S. subsidiaries have final tax assessment through 2006.

NOTE 15:- GEOGRAPHIC INFORMATION

Allot operates in a single reportable segment. Revenues are based on the customer's location:

	Year ended December 31,		
	2010	2009	2008
Europe	\$ 30,434	\$ 18,735	\$ 12,221
Asia and Oceania	12,469	11,004	11,235
United States of America	7,680	6,316	7,582
Middle East and Africa	3,890	2,992	2,752
Americas (excluding United States of America)	2,499	2,704	3,311
	<u>\$ 56,972</u>	<u>\$ 41,751</u>	<u>\$ 37,101</u>

During the year ended December 2010 and 2009, approximately 30% and 15% of the Company's revenues derived from a single customer. During 2008, no single customer accounted for more than 10% of the Company's revenues.

The following presents total long-lived assets as of December 31, 2010 and 2009:

	December 31,	
	2010	2009
Long-lived assets:		
Israel	\$ 8,650	\$ 9,270
United States of America	265	300
Other	134	173
	<u>\$ 9,049</u>	<u>\$ 9,743</u>

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

U.S. dollars in thousands, except share and per share data

NOTE 16:- FINANCIAL AND OTHER EXPENSES, NET

	Year ended December 31,		
	2010	2009	2008
Financial and other income:			
Interest income	\$ (492)	\$ (914)	\$ (2,571)
Financial and other expenses:			
Interest expenses (income) and other miscellaneous	216	(137)	388
Foreign currency transactions differences	471	52	0
Impairment related to Auction-Rate Securities, net	7,712	3,036	7,700
	<u>\$ 7,907</u>	<u>\$ 2,311</u>	<u>\$ 5,517</u>

**MANAGEMENT'S DISCUSSION AND ANALYSIS OF
FINANCIAL CONDITION AND RESULTS OF OPERATIONS**

A. Operating Results

Overview

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

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

In 2010, the primary driver of our growth was the mobile market, which was highlighted by our ongoing relationship with a global Tier 1 mobile operator group. Revenues from this customer in 2010 accounted for 30% of our total revenues.

Revenues

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

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

Customer concentration. We derived 30% and 15% of our total revenues in 2010 and 2009, respectively, from one global Tier 1 mobile operator group. In 2008, no single customer accounted for 10% or more of our revenues. The increase in 2010 is primarily attributable to deployment of our products in additional sites of the Tier 1 mobile operator group.

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

	Year Ended December 31,		
	2008	2009	2010
United States	21%	15%	14%
Europe	33	45	53
Asia and Oceania	30	26	22
Middle East and Africa	7	7	7
Americas (excluding United States)	9	7	4
Total	100%	100%	100%

Cost of revenues and gross margins

Our products' cost of revenues consists primarily of costs of materials, manufacturing services and overhead, warehousing, product testing and royalties paid primarily to the Office of the Chief Scientist of the Israeli Ministry of Industry, Trade and Labor, or the Office of the Chief Scientist. Our services' cost of revenues consist primarily of salaries and related personnel costs for our customer support staff as well as the royalty payments mentioned above. We expect cost of revenues to increase as a result of an increase in our product and service revenues, an increase in sales of our higher end products, primarily our Service Gateway platforms, and sales of extended service suites to large customers that we expect will require additional personnel hiring and other operational expenditures related to such sales. Such increases may be partially offset by increased sales of our network management application suites as their related cost of revenues is generally lower. As a result, our gross margins as a percentage of revenues may decrease in the future.

Operating expenses

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

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

General and administrative. Our general and administrative expenses consist of salaries and related personnel costs, rental expenses, costs for professional services and depreciation. We expect these expenses to increase on an absolute basis as we hire additional personnel and incur additional costs related to the growth of our business as we increase our global presence. General and administrative expenses also include costs associated with corporate governance, tax compliance, compliance with the rules implemented by the U.S. Securities and Exchange Commission and NASDAQ and premiums for our director and officer liability insurance.

Financial expenses, net

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

As of December 31, 2010, we held \$15.5 million in available for sale marketable securities. The increase in financial and other expenses, net in 2010 compared to 2009 is primarily attributable to the release of \$5.5 million of unrealized losses that were recorded as a separate component in equity and resulted from a net impairment related to auction-rate securities (ARS) recorded in previous periods that were sold during 2010 and an additional loss recorded to the same ARS in the amount of \$2.2 million in 2010.

In addition, financial and other income (expenses), net, may fluctuate due to foreign currency exchange gains or losses, as well as interest rate changes. See “—Factors Affecting Our Performance”.

Approved and Privileged Enterprise

Our facilities in Hod-Hasharon, Israel have been granted Approved Enterprise status under the Encouragement of Capital Investments Law, 1959 and enjoy certain tax benefits under this program. We expect to utilize these tax benefits after we utilize our net operating loss carryforwards. As of December 31, 2010, our net operating loss carryforwards for Israeli tax purposes totaled approximately \$43.0 million. Income derived from other sources, other than through our "Approved Enterprise" status, during the benefit period will be subject to the regular corporate tax rate.

Government Grants

Our research and development efforts have been financed, in part, through grants from the Office of the Chief Scientist under our approved plans in accordance with the Israeli Law for Encouragement of Research and Development in the Industry, 1984, or the Research and Development Law. Through December 31, 2010, we had received approval and recorded in our books grants totaling \$22.0 million from the Office of the Chief Scientist, including \$4.1 million attributed to NetReality products. Under Israeli law and the approved plans, royalties on the revenues derived from sales of all of our products are payable to the Israeli government, generally at the rate of 3.0% during the first three years and 3.5% beginning in the fourth year, up to the amount of the received grants as adjusted for fluctuation in the U.S. dollar/shekel exchange rate. The amounts received after January 1, 1999 bear interest at the twelve-month LIBOR as at the beginning of the year in which a grant is approved. Our obligation to pay these royalties is contingent upon actual consolidated sales of our products and no payment is required if no sales are made. As of December 31, 2010, we had an outstanding contingent obligation to pay royalties in the amount of \$11.7 million.

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

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

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

Factors Affecting Our Performance

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

Customer concentration. We derived 30% of our total revenues in 2010 from one global Tier 1 mobile operator group. While we have some visibility into the likely scope of the customer's projects, our relationship is conducted solely on a purchase order basis and we do not have any commitment for future purchase orders from this customer. The loss of such significant customer could harm our results of operations and financial condition.

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

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

Cost of revenues and cost reductions. Our cost of revenues as a percentage of total revenues was 26.1% for 2008, 28.3% for 2009 and 28.1% for 2010. Our products use off-the-shelf components and typically the prices of such components decline over time. However, the introduction and sale of new or enhanced products and services may result in an increase in our cost of revenues. We make a continuous effort to identify cheaper components of comparable performance and quality. We also seek improvements in engineering and manufacturing efficiency that will reduce costs. Since our cost of revenues also include royalties paid to the Office of the Chief Scientist, our cost of sales may be impacted positively or negatively by the Israeli government changing the royalty rate. Our products incorporate features that require the payment of royalties to third parties. In addition, new products usually have higher costs during the initial introduction period. We generally expect such costs to decline as the product matures and sales volume increases. The introduction of new products may also involve a significant decrease in demand for older products. Such a decrease may result in a devaluation or write-off of such older products and their respective components. In 2010, we recorded a write-off of \$1.1 million of inventory to our cost of revenues for products and components. The growth of our customer base is usually coupled with increased service revenues primarily resulting from increased maintenance and support. In addition, the growth of our installed base with large service providers may result in increased demand for professional services, such as training and installation services. An increase in demand for such services may require us to hire additional personnel and incur other expenditures. However, these additional expenses, handled efficiently, may be utilized to further support the growth of our customer base and increase service revenues.

Currency exposure. A majority of our revenues and a substantial portion of our expenses are denominated in the U.S. dollar. However, a significant portion of the expenses associated with our global operations, including personnel and facilities-related expenses, are incurred in currencies other than the U.S. dollar. This is the case primarily in Israel and to a lesser extent in other countries in Europe and Asia. Consequently, a decrease in the value of the U.S. dollar relative to local currencies will increase the dollar cost of our operations in these countries. A relative decrease in the value of the U.S. dollar would be partially offset to the extent that we generate revenues in such currencies. In order to partially mitigate this exposure we have decided in the past and may decide from time to time in the future to enter into hedging transactions. We may discontinue hedging activities at any time. As such decisions involve substantial judgment and assessments primarily regarding future trends in foreign exchange markets, which are very volatile, as well as our future level and timing of cash flows of these currencies, we cannot provide any assurance that such hedging transactions will not affect our results of operations when they are realized. See Note 6 to our consolidated financial statements included elsewhere in this annual report for further information.

Interest rate exposure. We have a significant amount of cash that is currently invested primarily in interest bearing vehicles, such as bank time deposits, money market funds, U.S. government treasury bills and available for sale marketable securities. These investments expose us to risks associated with interest rate fluctuations.

Critical Accounting Policies and Estimates

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

- Revenue Recognition
- Allowance for Doubtful Accounts
- Accounting for Stock-Based Compensation
- Inventories
- Marketable Securities
- Impairment of Goodwill and Long Lived Assets
- Contingencies

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

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

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

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

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

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

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

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

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

In connection with the grant of options, we recorded total stock-based compensation expense of \$1.7 million in 2008, \$2.3 million in 2009 and \$2.0 million in 2010. In 2010, \$0.1 million, \$0.3 million, \$0.9 million and \$0.7 million of our stock-based compensation expense resulted from cost of revenue, research and development expenses, sales and marketing expenses and general and administrative expenses, respectively, based on the department in which the recipient of the option grant was employed. As of December 31, 2010, we had an aggregate of \$3.5 million of deferred unrecognized stock-based compensation remaining to be recognized. We estimate that this deferred unrecognized stock-based compensation balance will be amortized as follows: \$1.6 million in 2011, \$1.0 million in 2012 and \$0.9 million in 2013 and thereafter.

Inventories. We value our inventories at the lower of cost or estimated market value. Cost is determined based on the First In, First Out (“FIFO”) cost method for raw materials and out-of-pocket manufacturing costs. Indirect costs are allocated on an average basis. We estimate market value based on our current pricing, market conditions and specific customer information. We write off inventory for slow-moving items or technological obsolescence. We also assess our inventories for obsolescence based upon assumptions about future demand and market conditions. Actual future results may differ from our assessments and result in further devaluations or write-downs that will affect our future results of operations. Once inventory is written off, a new cost basis for these assets is established for future periods. Inventory write offs totaled \$0.2 million in 2008, \$0.8 million in 2009 and \$1.1 million in 2010.

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

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

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

In April 2009, we adopted the Financial Accounting Standards Board’s updated guidance relating to investments and debt securities, which amends the other-than-temporary impairment (“OTTI”) guidance in U.S. GAAP. Under the updated guidance, if other-than-temporary impairment occurs, and it is more likely than not that we will not sell the investment or debt security before the recovery of its amortized cost basis, then the other-than-temporary impairment is separated into (a) the amount representing the credit loss and (b) the amount related to all other factors. The amount of the total other-than-temporary impairment related to credit loss is recognized in earnings. The amount of the total other-than-temporary impairment related to other factors is recognized in accumulated other comprehensive income. As a result of the adoption of this updated accounting guidance, we recorded a cumulative effect adjustment of \$7.7 million to reclassify the non-credit component of previously recognized impairments from accumulated deficit to accumulated other comprehensive income (loss). See Note 4 to our consolidated financial statements included elsewhere in this annual report for further information.

During 2010, we sold our entire ARS portfolio, reclassified the loss recorded in accordance with ASC No. 320 in accumulated other comprehensive loss in the amount of \$5.5 million to financing expenses net and recognized an additional loss of \$2.2 million.

As of December 31, 2010, we held available for sale marketable securities of \$15.5 million. As of December 31, 2010, the unrealized loss recorded to other comprehensive income was immaterial.

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

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

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

Our long lived assets consist primarily of property and equipment and other intangible assets. Our long lived assets are amortized using the straight-line basis over their estimated useful lives. The carrying amount of these assets to be held and used is reviewed whenever events or changes in circumstances indicate that the carrying value of an asset may not be recoverable. Recoverability of these assets is measured by comparison of the carrying amount of the asset to the future undiscounted cash flows the asset is expected to generate. If the asset is considered to be impaired, the amount of any impairment is measured as the difference between the carrying value and the fair value of the impaired asset. As this test requires considerable judgment and estimation of future cash flows, changes in these estimations may affect our results of operations significantly. Based on the impairment test performed as of December 31, 2010, no impairment was identified.

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

Recent Accounting Pronouncements

In September 2009, the FASB reached a consensus on Accounting Standards Update 2009-13, Revenue Recognition (Topic 605) — Multiple-Deliverable Revenue Arrangements (“ASU 2009-13”) and Accounting Standards Update 2009-14, Software (Topic 985) — Certain Revenue Arrangements That Include Software Elements (“ASU 2009-14”). ASU 2009-13 modifies the requirements that must be met for an entity to recognize revenue from the sale of a delivered item that is part of a multiple-element arrangement when other items have not yet been delivered. ASU 2009-13 establishes a selling price hierarchy that allows for the use of an estimated selling price to determine the allocation of arrangement consideration to a deliverable in a multiple element arrangement where neither VSOE nor third-party evidence, or TPE, is available for that deliverable. In the absence of VSOE or TPE of the standalone selling price for one or more delivered or undelivered elements in a multiple-element arrangement, entities are required to estimate the selling prices of those elements. Overall arrangement consideration is allocated to each element (both delivered and undelivered items) based on their relative selling prices, regardless of whether those selling prices are evidenced by VSOE or TPE or are based on the entity’s estimated selling price. The residual method of allocating arrangement consideration has been eliminated.

The amendments in ASU 2009-13 and ASU 2009-14 are effective for fiscal years, and interim periods within those years, beginning of their first fiscal year beginning on or after 15 June 2010. Entities may elect to adopt this amendment through either prospective application for revenue arrangements entered into, or materially modified, after the effective date or through retrospective application to all revenue arrangements for all periods presented. Early adoption is permitted;

ASU 2009-14 modifies the software revenue recognition guidance to exclude from its scope tangible products that contain both software and non-software components that function together to deliver a product's essential functionality. However, an entity must select the same transition method and same period for the adoption of both ASU 2009-13 and ASU 2009-14.

We adopted ASU 2009-13 and ASU 2009-14 as of January 1, 2011. Therefore, we will not account for our products sales following the adoption of ASU 2009-14 in accordance with ASC No. 985-605. We are currently evaluating the impact of the adoption of ASU 2009-13 and ASU 2009-14 on our consolidated financial statements.

The Company may elect to adopt the update prospectively, to new or materially modified arrangements beginning on the adoption date, or retrospectively, for all periods presented.

Results of Operations

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

	Year Ended December 31,		
	2008	2009	2010
<i>Revenues:</i>			
Products	73.1%	71.0%	71.7%
Services	26.9	29.0	28.3
<i>Total revenues</i>	100.0	100.0	100.0
<i>Cost of revenues:</i>			
Products	22.1	24.2	24.6
Services	4.0	4.2	3.5
<i>Total cost of revenues</i>	26.1	28.4	28.1
Gross profit	73.9	71.6	71.9
<i>Operating expenses:</i>			
Research and development, net	32.2	22.1	19.8
Sales and marketing	53.3	48.9	38.7
General and administrative	16.6	13.3	9.6
In process research and development	0.7	-	-
<i>Total operating expenses</i>	102.8	84.3	68.1
Operating profit (loss)	(28.9)	(12.7)	3.8
Financing and other expenses, net	(14.9)	(5.5)	(13.8)
Loss before income tax expense	(43.9)	(18.2)	(10.0)
Income tax expense	0.6	0.1	0.1
Net loss	(44.5)%	(18.3)%	(10.1)%

Revenues

Products. Product revenues increased by \$11.3 million, or 38%, to \$40.9 million in 2010 from \$29.6 million in 2009. The increase is primarily attributable to increased sales of our high-end products, primarily the Service Gateway platforms, driven by orders placed by a global Tier 1 mobile operator group. The increase in 2010 is primarily attributable to deployment of our products in additional sites of the Tier 1 mobile operator group.

Services. Services revenues increased by \$4.0 million, or 33%, to \$16.1 million in 2010 from \$12.1 million in 2009. The increase in services revenues is primarily attributable to an increase in our installed base in 2010.

Product revenues comprised 71.7% of our total revenues in 2010, an increase of 0.7% compared to 2009 while services revenues' portion of total revenues decreased by a similar percentage.

During 2010, revenues in Europe increased by \$11.7 million, or 62%, compared to 2009, which was primarily attributable to orders placed by a global Tier 1 mobile operator group. Revenues in the Americas increased by \$1.2 million, or 13%, in 2010 compared to 2009, and revenues in Asia and Oceania increased by \$1.5 million, or 13%, in 2010 compared to 2009. Revenues in the Middle East and Africa increased by \$0.9 million, or 30%, compared to 2009.

Cost of revenues and gross margin

Products. Products cost of revenues increased by \$3.9 million, or 39%, to \$14 million in 2010 from \$10.1 million in 2009. This increase is consistent with the increase in product revenues. Product gross margin slightly decreased to 65.7% in 2010 from 65.9% in 2009.

Services. Services cost of revenues increased by \$0.3 million, or 18 %, to \$2.0 million in 2010 from \$1.7 million in 2009. This increase is primarily attributable to higher support personnel expenses associated with deployment of our products with large service providers. Services gross margin increased to 87.8 % in 2010 from 85.7% in 2009.

Total gross margin increased marginally to 71.9% in 2010 from 71.6% in 2009. This increase is primarily attributable to the increase in services gross margin as described above.

Operating expenses

Research and development. Gross research and development expenses increased by \$2.3 million, or 20%, to \$14.0 million in 2010 from \$11.7 million in 2009. This increase is primarily attributable to an increase in salaries and labor costs of approximately \$1.5 million, which principally resulted from a minor increase in head count, an increase in accrued bonuses and the devaluation of the U.S. dollar relative to the shekel. In addition, costs of materials and contractors increased by \$0.5 million and depreciation and other overhead expenses increased by \$0.3 million.

Research and development expenses, net of received and accrued grants from the Office of the Chief Scientist, increased by \$2.0 million, or 22%, to \$11.3 million in 2010 from \$9.3 million in 2009. Grants received from the Office of the Chief Scientist totaled \$2.8 million in 2010 compared to \$2.4 million in 2009. The increase in grants received is attributable to an increase in the approved grants from the Office of the Chief Scientist, and the devaluation of the U.S. dollar relative to the shekel. Research and development expenses, net, as a percentage of revenues decreased to 20% in 2010 from 22% in 2009.

Sales and marketing. Sales and marketing expenses increased by \$1.6 million, or 8%, to \$22.0 million in 2010 from \$20.4 million in 2009. This increase is primarily attributable to increased salaries of approximately \$0.9 million, resulted from increased head count, an increase in accrued bonuses and the devaluation of the U.S. dollar relative to the shekel. Commission expenses increased by approximately \$0.9 million resulting from increased sales, and other overhead expenses increased by \$0.3 million. The increase of the expenses was partially offset by a decrease in depreciation expenses that resulted from a write-off of old demonstration units of \$0.4 million in 2009.

Sales and marketing expenses, as a percentage of total revenues decreased to 39% in 2010 from 49% in 2009.

General and administrative. General and administrative expenses in 2010 was \$5.5 million, the same level as in 2009. Increased accrued bonuses of \$0.2 million and minor increases in salaries resulted mainly from the devaluation of the U.S. dollar relative to the shekel, and a slight increase in professional services were offset by a decrease in stock-based compensation expenses.

General and administrative expenses as a percentage of revenues decreased to 10% in 2010 from 13% in 2009.

Financial and other income (expenses), net. Financial and other expenses, net increased to \$7.9 million in 2010 from \$2.3 million in 2009. The increase in financial and other expenses, net is primarily attributable to a loss in the amount of \$7.7 million related to our investment in ARS and an increase of \$0.5 million in foreign currency transactions and other related financial expenses. This was partially offset by a decrease in interest received on cash balances and marketable securities of \$0.4 million, which was primarily attributable to a decline in interest rates in 2010.

Income tax expense. Income tax expense in 2010 was \$0.1 million, the same level as in 2009.

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

Revenues

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

Services. Services revenues increased by \$2.1 million, or 21.3%, to \$12.1 million in 2009 from \$10.0 million in 2008. The increase in services revenues is primarily attributable to an increase in our installed base.

Products revenues comprised 71% of our total revenues in 2009a decrease of 2.1% compared to 2008, while services revenues increased by a similar percentage.

During 2009, revenues in Europe increased by \$6.5 million, or 53%, compared to 2008, which was primarily attributable to an agreement signed with a global Tier 1 mobile operator group. Revenues in the Americas decreased by \$1.9 million, or 17%, compared to 2008. Revenues in Asia and Oceania decreased by \$0.2 million, or 2%, compared to 2008. Revenues in the Middle East and Africa increased by \$0.2 million, or 9%, compared to 2008.

Cost of revenues and gross margin

Products. Products cost of revenues increased by \$1.9 million, or 23%, to \$10.0 million in 2009 from \$8.2 million in 2008. This increase is consistent with the increase in product revenues. Product gross margin decreased to 65.9% in 2009 from 69.7% in 2008. This decrease is primarily attributable to higher sales volume of our high-end products, which require higher material and labor costs as well as an increased inventory write-off, of which \$0.5 million is attributable to the introduction of new products in 2009.

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

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

Operating expenses

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

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

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

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

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

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

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

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

B. Liquidity and Capital Resources

From our inception until the consummation of our initial public offering in 2006 we financed our operations primarily through private placements of our equity securities and, to a lesser extent, through borrowings from financial institutions. Sales of our equity securities including the consummation of our initial public offering resulted in net proceeds to us of approximately \$134.0 million, net of issuance expenses.

As of December 31, 2010, we had \$42.9 million in cash and cash equivalents, \$15.5 million available for sale marketable securities, and \$1.1 million in restricted cash and deposits. As of December 31, 2010, our working capital, which we calculate by subtracting our current liabilities from our current assets, was \$52.3 million.

Based on our current business plan, we believe that our existing cash balances, will be sufficient to meet our anticipated cash needs for working capital and capital expenditures for at least the next twelve months. If our estimates of revenues, expense or capital or liquidity requirements change or are inaccurate and are insufficient to satisfy our liquidity requirements, we may seek to sell additional equity or arrange additional debt financing. In addition, we may seek to sell additional equity or arrange debt financing to give us financial flexibility to pursue attractive acquisition or investment opportunities that may arise in the future.

Operating activities. During 2010, we generated \$7.3 million in cash and cash equivalents from operating activities. Net cash provided by operating activities consisted of a net loss of \$5.8 million, an increase of \$5.8 million in inventories, an increase of \$1.5 million in other receivables and prepaid expenses and an increase in trade payable of \$2.0 million. The above changes were partially offset by non-cash expenses primarily attributable to a loss of \$7.7 million related to the sale of our ARS portfolio, depreciation and amortization of fixed and intangible assets of \$2.7 million, \$2.0 million of stock-based compensation expense and an increase of \$7.2 million in deferred revenues attributable to sales for which the Company received cash but the revenue recognition criteria has not been met.

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

Investing activities. Net cash used in investing activities in 2010 was \$4.0 million, primarily attributable to the redemption and sale of marketable securities of \$13.6 million, redemption of short-term deposits of \$1.3 million, \$0.2 million in proceeds from sales of property and equipment offset by the purchase of property and equipment of \$2.3 million and an investment in available for sale marketable securities of \$16.8 million.

Net cash used in investing activities in 2009 was \$3.7 million, primarily attributable to the purchase of property and equipment of \$3.6 million and a \$0.2 million increase in short-term bank deposits and restricted cash and deposits offset by \$0.1 million in proceeds from the sale of property and equipment.

We expect that our capital expenditures will total approximately \$2.3 million in 2011. We anticipate that these capital expenditures will be primarily related to further investments in lab equipment for research and development, as well as customer support and demo units.

Financing activities. Net cash provided by financing activities in 2010 was \$3.0 million, which was attributable to the issuance of share capital through the exercise of stock options.

Net cash provided by financing activities in 2009 was \$0.5 million, which was attributable to the issuance of share capital through the exercise of stock options.

C. Research and Development, Patents and Licenses

Our research and development activities take place in Israel and New Zealand. As of December 31, 2010, 95 of our employees were engaged primarily in research and development. We devote a significant amount of our resources towards research and development to introduce and continuously enhance products to support our growth strategy.

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

Total research and development expenses, before royalty bearing grants, were approximately \$14.6 million, \$11.7 million and \$14.0 million in the years ended December 31, 2008, 2009 and 2010, respectively. Royalty bearing grants amounted to \$2.7 million, \$2.4 million and \$2.8 million in 2008, 2009 and 2010, respectively.

E. Off-Balance Sheet Arrangements

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

F. Contractual Obligations

The following table of our material contractual and other obligations known to us as of December 31, 2010, summarizes the aggregate effect that these obligations are expected to have on our cash flows in the periods indicated.

Contractual Obligations	Payments due by period				
	Total	Less than 1 year	1-3 years	3-5 years	Over 5 years
		(in thousands of U.S. dollars)			
Operating leases — offices(1)	\$ 2,150	\$ 848	\$ 1,222	\$ 80	\$ -
Operating leases — vehicles	663	369	294	-	-
Purchase obligations	3,672	3,672	-	-	-
Accrued severance pay(2)	191	-	-	-	191
Other(3)	75	75	-	-	-
Total	<u>\$ 6,751</u>	<u>\$ 4,964</u>	<u>\$ 1,516</u>	<u>\$ 80</u>	<u>\$ 191</u>

- (1) Consists primarily of an operating lease for our facilities in Hod-Hasharon, Israel, as well as operating leases for facilities leased by our subsidiaries.
- (2) Severance pay relates to accrued severance obligations to our Israeli employees as required under Israeli labor law. These obligations are payable only upon termination, retirement or death of the respective employee and there is no obligation if the employee voluntarily resigns. Of this amount, \$0.2 million is unfunded.
- (3) Uncertain income tax position under FASB ASC No. 740-10, "Income Taxes," (originally issued as FIN 48) is due upon settlement, and we are unable to reasonably estimate the ultimate amount or timing of settlement. See Note 14 to our consolidated financial statements included elsewhere in this annual report for further information regarding our liability under ASC No. 740-10.

CONTROLS AND PROCEDURES

Disclosure Controls and Procedures:

Our management, including our Chief Executive Officer and Chief Financial Officer, has evaluated the effectiveness of our disclosure controls and procedures (as such term is defined in Rules 13a-15(e) and 15d-15(e) under the Exchange Act) as of December 31, 2010. Based on such evaluation, our Chief Executive Officer and Chief Financial Officer have concluded that, as of December 31, 2010, our disclosures controls and procedures were effective at the reasonable assurance level.

Management's Annual Report on Internal Control over Financial Reporting

Our management is responsible for establishing and maintaining adequate internal control over our financial reporting. Internal control over financial reporting is defined in Rule 13a-15(f) or 15d-15(f) promulgated under the Exchange Act as a process designed by, or under the supervision of, the company's principal executive and principal financial officers and effected by the company's board of directors, management and other personnel, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles and includes those policies and procedures that:

- pertain to the maintenance of records that in reasonable detail accurately and fairly reflect the transaction and dispositions of the assets of the company;
- provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and
- provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use or disposition of the company's assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

Our management assessed the effectiveness of our internal control over financial reporting as of December 31, 2010. In making this assessment, our management used the criteria set forth by the Committee of Sponsoring Organizations of the Treadway Commission (COSO) in Internal Control-Integrated Framework. Based on that assessment, our management concluded that as of December 31, 2010, our internal control over financial reporting was effective.

Our independent auditors, Kost Forer Gabbay & Kasierer, a member of Ernst & Young Global, have issued an audit report on the effectiveness of our internal control over financial reporting. The report is included with our consolidated financial statements included elsewhere in this annual report.

Consent of Independent Registered Public Accounting Firm

We consent to the incorporation by reference in the Registration Statement on Form S-8 (Nos. 333-140701, 333-149237, 333-159306, 333-165144 and 333-172492) pertaining to the incentive compensation plan and on Form F-3/A (No. 333-171053) of our report dated March 31, 2011, with respect to the consolidated financial statements of Allot Communications Ltd. for the year ended December 31, 2010 and the effectiveness of internal control over financial reporting of Allot Communications Ltd. included in this Current Report on Form 6-K.

March 31, 2011
Haifa, Israel

/s/ KOST FORER GABBAY & KASIERER
KOST FORER GABBAY & KASIERER
A Member of Ernst & Young Global
