MER TELEMANAGEMENT SOLUTIONS LTD
Form 20-F
April 08, 2008

SECURITIES AND EXCHANGE COMMISSION
WASHINGTON D.C. 20549

FORM 20-F

[_] REGISTRATION STATEMENT PURSUANT TO SECTION 12(B) OR (G) OF THE SECURITIES EXCHANGE ACT OF 1934

OR

[X] ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(D) OF THE SECURITIES EXCHANGE ACT OF 1934

FOR THE FISCAL YEAR ENDED DECEMBER 31, 2007

OR

[_] TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(D) OF THE SECURITIES EXCHANGE ACT OF 1934

FOR THE TRANSITION PERIOD FROM _____ TO _____

[_] SHELL COMPANY REPORT PURSUANT TO SECTION 13 OR 15(D) OF THE SECURITIES EXCHANGE ACT OF 1934

Date of event requiring this shell company report .....

COMMISSION FILE NUMBER: 0-28950

MER TELEMANAGEMENT SOLUTIONS LTD.
(Exact Name of Registrant as specified in its charter
and translation of Registrant's name into English)

ISRAEL
(Jurisdiction of incorporation or organization)

22 ZARHIN STREET, RA'ANANA 43662, ISRAEL
(Address of principal executive offices)

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

| Title of each class | Name of each exchange on which registered |
|---|---|
| ORDINARY SHARES, NIS 0.1 PAR VALUE | NASDAQ CAPITAL MARKET |

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

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

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

ORDINARY SHARES, PAR VALUE NIS 0.01 PER SHARE.....5,773,845
(as of December 31, 2007)

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

Yes [_] No [X]

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

Yes [_] No [X]

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

Yes [X] No [_]

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

Large accelerated filer [_] Accelerated filer [_] Non-accelerated filer [X]

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

Item 17 [_] Item 18 [X]

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

Yes [_] No [X]

This Report on Form 20-F is incorporated by reference into our Form F-3 Registration Statement File No. 333-128225 and into our Form S-8 Registration Statements File No. 333-12014 and 333-123321.

## INTRODUCTION

Mer Telemanagement Solutions Ltd. is a worldwide provider of solutions for telecommunications expense management, or TEM, used by enterprises, and billing solutions, used by information and telecommunication service providers. Our TEM solutions assist enterprises and organizations to make smarter choices with their telecommunications spending at each stage of the service lifecycle, including allocation of cost, proactive budget control, fraud detection, processing of payments and spending forecasting. Our converged billing solutions have been successfully implemented worldwide by wireless providers, Voice over Internet Protocol, Internet Protocol Television, and content service providers. Our converged billing solutions include applications for charging and invoicing customers, interconnect billing and partner revenue management using pre-pay and post-pay schemes.

Since our public offering in May 1997, our ordinary shares have been listed on the NASDAQ Stock Market (symbol: MTSL) and are presently listed on the NASDAQ Capital Market. As used in this annual report, the terms "we," "us" and "our" mean Mer Telemanagement Solutions Ltd. and its subsidiaries, unless otherwise indicated.

We have obtained a U.S. trademark registration for TABS by MER(R) and have common law rights in the trademarks TABS.IT, FACILITRAK, and PMSI, based on use of the marks in the United States. We have also acquired rights in the TOTAL-e(TM) trademark in connection with the products we acquired from Teleknowledge Group Ltd. in December 2004. Additionally, in connection with the assets we acquired from TelSoft Solutions, Inc. in July 2006, we have acquired the rights in the CALLTRAC(R) registered trademark and the common law trademarks and service marks TELSOFT SOLUTIONS, TELSOFT, MEGACALL, CALLTRAC LITE, MEGAPOLL, MEGABILL, MEGABILL-BACK and MEGASYNC. All other trademarks and trade names appearing in this annual report owned by their respective holders.

Our consolidated financial statements appearing in this annual report are prepared in U.S. dollars and in accordance with generally accepted accounting principles in the United States, or U.S. GAAP. All references in this annual report to "dollars" or "$" are to U.S. dollars and all references in this annual report to "NIS" are to New Israeli Shekels.

Statements made in this annual report concerning the contents of any contract, agreement or other document are summaries of such contracts, agreements or documents and are not complete descriptions of all of their terms. If we filed any of these documents as an exhibit to this annual report or to any registration statement or annual report that we previously filed, you may read the document itself for a complete description of its terms.

Except for the historical information contained in this annual report, the statements contained in this annual report are "forward-looking statements" within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended, and the Private Securities Litigation Reform Act of 1995, as amended, with respect to our business, financial condition and results of operations. Such forward-looking statements reflect our current view with respect to future events and financial results. We urge you to consider that statements which use the terms "anticipate," "believe," "do not believe," "expect," "plan," "intend," "estimate," "anticipate" and similar expressions are intended to identify forward-looking statements. We remind readers that forward-looking statements are merely predictions and therefore inherently subject to uncertainties and other factors and involve known and unknown risks that could cause the actual results, performance, levels of activity, or our achievements, or industry results, to be materially different from any future results, performance, levels of activity, or our achievements expressed or implied by such forward-looking statements. Such forward-looking statements are also included in Item 4 - "Information on the Company" and Item 5 - "Operating and Financial Review and Prospects." Readers are cautioned not to place undue reliance on these forward-looking statements, which speak only as of the date hereof. Except as required by applicable law, including the securities laws of the United States, we undertake no obligation to publicly release any update or revision to any forward-looking statements to reflect new information, future events or circumstances, or otherwise after the date hereof. We have attempted to identify significant uncertainties and other factors affecting forward-looking statements in the Risk Factors section that appears in Item 3D. "Key Information - Risk Factors."

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## PART I

### ITEM 1. IDENTITY OF DIRECTORS, SENIOR MANAGEMENT AND ADVISERS

Not applicable.

### ITEM 2. OFFER STATISTICS AND EXPECTED TIMETABLE

Not applicable.

### ITEM 3. KEY INFORMATION

A. SELECTED FINANCIAL DATA

The following selected consolidated financial data for and as of the five years ended December 31, 2007 are derived from our audited consolidated financial statements, which have been prepared in accordance with U.S. GAAP. Our audited consolidated financial statements with respect to the three years ended December 31, 2007 and as of December 31, 2006 and 2007 appear elsewhere in this Annual Report. Our selected consolidated financial data as of December 31, 2005, 2004 and 2003 and for the years ended December 31, 2004 and 2003 have been derived from audited consolidated financial statements not included in this Annual Report. The selected consolidated financial data set forth below should be read in conjunction with Item 5. "Operating and Financial Review and Prospects," and our consolidated financial statements and notes thereto included elsewhere in this annual report.

STATEMENT OF OPERATIONS DATA:

| | Year Ended December 31, | | | |
|---|---|---|---|---|
| | 2003 | 2004 | 2005 | |
| | | (in thousands, except share and per | | |
| Revenues | $ 9,230 | $ 9,413 | $ 11,563 | $ |
| Cost of revenues | 1,849 | 2,814 | 3,802 | |
| Gross profit | 7,381 | 6,599 | 7,761 | |
| Selling and marketing | 3,916 | 6,300 | 4,797 | |
| Research and development, net | 1,825 | 2,362 | 4,395 | |
| General and administrative | 1,830 | 2,101 | 2,830 | |
| Impairment of goodwill and other intangible assets | -- | -- | -- | |
| Operating loss | (190) | (4,164) | (4,261) | |
| Financial (expenses) income, net | 130 | 78 | 53 | |
| Capital loss on sale of long-term investment | -- | -- | -- | |
| Loss before taxes on income | (60) | (4,086) | (4,208) | |
| Taxes on income (benefit), net | 198 | 266 | 10 | |
| Net loss before equity in earnings (losses) of affiliate | (258) | (4,352) | (4,218) | |
| Equity in earnings (losses) of affiliate | 345 | 225 | 2 | |
| Net loss | $ 87 | $ (4,127) | $ (4,216) | $ |
| Basic and diluted net loss per share | $ 0.02 | $ (0.89) | $ (0.83) | $ |
| Weighted average number of ordinary shares used in computing basic net loss per share | 4,617,099 | 4,634,413 | 5,092,117 | |
| Weighted average number of ordinary shares used in computing diluted net loss per share | 4,628,249 | 4,634,413 | 5,092,117 | |

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BALANCE SHEET DATA:

| | As of December 31, | | | | |
|---|---|---|---|---|---|
| | 2003 | 2004 | 2005 | 2006 | 2007 |
| | | | (in thousands) | | |
| Working capital | $ 9,437 | $ 2,773 | $ 2,065 | $ 186 | $(2,014) |
| Total assets | 18,182 | 15,323 | 13,816 | 14,054 | 8,478 |
| Long-term loans | -- | -- | -- | 583 | -- |

| | | | | | |
|---|---|---|---|---|---|
| Shareholders' equity | 14,464 | 10,657 | 9,174 | 7,542 | 1,569 |

B. CAPITALIZATION AND INDEBTEDNESS

Not applicable.

C. REASONS FOR THE OFFER AND USE OF PROCEEDS

Not applicable.

D. RISK FACTORS

INVESTING IN OUR ORDINARY SHARES INVOLVES A HIGH DEGREE OF RISK AND UNCERTAINTY. YOU SHOULD CAREFULLY CONSIDER THE RISKS AND UNCERTAINTIES DESCRIBED BELOW BEFORE INVESTING IN OUR ORDINARY SHARES. IF ANY OF THE FOLLOWING RISKS ACTUALLY OCCURS, OUR BUSINESS, PROSPECTS, FINANCIAL CONDITION AND RESULTS OF OPERATIONS COULD BE HARMED. IN THAT CASE, THE VALUE OF OUR ORDINARY SHARES COULD DECLINE, AND YOU COULD LOSE ALL OR PART OF YOUR INVESTMENT.

RISKS RELATING TO OUR BUSINESS AND MARKET

WE HAVE HAD A RECENT HISTORY OF OPERATING LOSSES AND MAY NOT ACHIEVE OR SUSTAIN PROFITABILITY IN THE FUTURE; TO THE EXTENT THAT WE CONTINUE TO INCUR OPERATING LOSSES, WE MAY NOT HAVE SUFFICIENT WORKING CAPITAL TO FUND OUR OPERATIONS IN THE FUTURE.

We have incurred operating losses in each of the last five fiscal years and we may not be able to achieve or sustain profitable operations in the future or generate positive cash flows from operations. As a result of our losses, our cash position has been severely adversely impacted. To the extent that we continue to incur operating losses, we may not have sufficient working capital to fund our operations in the future. If we do not generate sufficient cash from operations, we will be required to obtain additional financing or reduce level of expenditure. Such financing may not be available in the future, or, if available, may not be on terms satisfactory to us. If adequate funds are not available to us, our business, and results of operations and financial condition will be materially and adversely affected.

OUR OPERATING RESULTS FLUCTUATE SIGNIFICANTLY.

Our quarterly results have fluctuated significantly in the past and are likely to fluctuate significantly in the future. Our future operating results will depend on many factors, including, but not limited to the following:

- demand for our products;
- changes in our pricing policies or those of our competitors;
- new product announcements by us and our competitors;
- the number, timing and significance of product enhancements;



- product life cycles;
- our ability to develop, introduce and market new and enhanced products on a timely basis;

- changes in the level of our operating expenses;
- budgeting cycles of our customers;
- customer order deferrals in anticipation of enhancements or new products that we or our competitors offer;
- changes in our strategy;
- seasonal trends and general domestic and international economic and political conditions, among others; and
- currency exchange rate fluctuations and economic conditions in the geographic areas where we operate.

Due to the foregoing factors, quarterly revenues and operating results are difficult to forecast, and it is likely that our future operating results will be adversely affected by these or other factors. Revenues are also difficult to forecast because the market for telecommunication management and billing solutions is rapidly evolving and our sales cycle for our solutions, from initial evaluation to purchase, is lengthy and varies substantially from customer to customer.

We typically ship orders for our TABS product line shortly after receipt of a purchase order and, consequently, order backlog at the beginning of any quarter has in the past represented only a small portion of that quarter's revenues. As a result, license revenues from our TABS product line in any quarter depend substantially on orders for TABS products that have been booked and shipped in that quarter. Also, we can not predict whether revenues from our Application Suite will be recognized in any quarter because the delivery and, in some cases, the implementation of all the components of the Application Suite (including among, other things, customer training) are dependent on the customers individual timing requirements, which can delay the completion of these orders. In addition, revenues from our billing solutions are generated by using contract accounting on a percentage of completion method and because the completion pace varies from quarter to quarter and is dependent on different variables that are out of our control, billing solutions revenues in any quarter depend on our customers' operational plans, which can delay our ability to progress and complete the projects.

Due to all of the foregoing, we cannot predict revenues for any future quarter with any significant degree of accuracy. Accordingly, we believe that period-to-period comparisons of our operating results are not necessarily meaningful and you should not rely upon them as indications of future performance. Our revenues declined in 2007 and 2006 and we may not be able to achieve or sustain revenue growth in the future.

OUR QUARTERLY FINANCIAL PERFORMANCE VARIES SIGNIFICANTLY.

We have often recognized a substantial portion of our revenues in the last quarter of the year and in the last month, or even weeks or days, of a quarter. Our expense levels are substantially based on our expectations for future revenues and are therefore relatively fixed in the short term. If revenue levels fall below expectations, our quarterly results are likely to be disproportionately adversely affected because a proportionately smaller amount of our expenses varies with our revenues. Our operating results are generally not characterized by a seasonal pattern, except that our sales in Europe are generally lower in the summer months.

Due to the foregoing, our quarterly financial performance has in the past and may in the future vary significantly. Our revenues and operating results in any quarter may not be indicative of our future performance and it may be

difficult for investors to evaluate our prospects. In some future quarter, our operating results may be below the expectations of public market analysts and investors. In such event, it is likely that the price of our ordinary shares would be materially and adversely affected.



WE DERIVE THE MAJORITY OF OUR REVENUES FROM TELECOMMUNICATIONS EXPENSE MANAGEMENT SOLUTIONS, THE MARKET FOR WHICH HAS DECLINED IN RECENT YEARS.

Until 2005, we derived substantially all of our revenues from our TABS.IT call accounting and billing products. In late 2004, we implemented a new strategy that led to the development and introduction of our Application Suite. The Application Suite is built on the Microsoft.Net platform and establishes a framework for us to provide customized solutions that include customer care and billing in addition to our traditional telecommunications expense management, or TEM, solutions. The main functions of our TABS.IT and prior WinTrak families of products were incorporated into the Application Suite. In 2005, we expanded and enhanced the functionality of the Application Suite to include invoice management, which facilitates bill reconciliation and dispute management. In July 2006, we completed the acquisition of certain assets and liabilities of TelSoft Solutions, Inc., or TelSoft, a California-based provider of call accounting and TEM solutions. Despite all of the foregoing, our revenues from our TEM solutions declined each year from 1999 until 2003 and again in 2006 and revenues for these products may not continue to grow in the future. If the market for our TEM solutions fails to grow in the future, our business, operating results and financial condition would be materially adversely affected. Our future financial performance will be dependent to a substantial degree on the successful introduction, marketing and customer acceptance of our invoice management products.

WE DEPEND ON BUSINESS TELEPHONE SYSTEM MANUFACTURERS, VENDORS AND DISTRIBUTORS FOR OUR SALES.

One of the primary distribution channels for our call accounting management products are private branch exchange, or PBX, original equipment manufacturers, or OEMs, and vendors who market our products to end-users in conjunction with their own products. We are highly dependent upon the active marketing and distribution efforts of our PBX OEMs. In 2005, 2006 and 2007, sales attributable to our largest OEM customer, Siemens Gmbh, represented approximately 36.0%, 29.0% and 26.4% of our total revenues, respectively.

As these and other PBX vendors expand their product offerings to offer a wider range of newer technologies such as the Internet, Wireless Fidelity, or WiFi, and voice over Internet protocol, or VoIP, we have enhanced our Application Suite to accommodate these new services. In late 2004 and early 2005, we entered into partnership agreements with each of NEC Unified Solutions, Inc. and Avaya Inc. for the integration of our products with their own products and the marketing of our integrated product. Sales of call accounting solutions by PBX manufacturers and vendors have declined markedly in the recent past, and sales through this channel may not recover. Our success will be dependent to a substantial degree on the marketing and sales efforts of such third parties in marketing and integrating our products. These third parties may not give priority to the sale of our products as an enhancement to their products. Although most of the major business telephone switching systems manufacturers and vendors currently rely on third-party suppliers to provide call accounting and other telemanagement products, these manufacturers and vendors, including our current customers, may develop their own competing products or purchase competing products from others.

Because we sell our products through local master distributors in countries where we do not have a marketing subsidiary, we are highly dependent upon the active marketing and distribution efforts of our distributors. We also depend in large part upon our distributors for product maintenance and support. Our distributors may not continue to provide adequate maintenance and support to end-users or provide maintenance and support for new products, which might cause us to seek new or additional distributors or incur additional service and support costs. The distributors to whom we sell our products are generally not contractually required to make future purchases of our products and could, therefore, discontinue carrying our products at any time. None of our distributors or resellers is subject to any minimum purchase requirements under their agreements with us. We may not be able to continue our relationships with our OEM customers or, if such relationships are not maintained, we may not be able to attract and retain comparable PBX original equipment manufacturers (OEMs). The loss of any of our major reseller or OEM relationships, either to competitive products offered by other companies or products developed by such resellers, would have a material adverse effect on our business, financial condition and results of operations. Our future performance will depend, in part, on our ability to attract additional PBX manufacturers and vendors that will be able to market and support our products effectively, especially in markets in which we have not previously distributed our products.



ON JULY 31, 2006, WE ACQUIRED CERTAIN ASSETS AND LIABILITIES OF TELSOFT SOLUTIONS, INC. AND WE MAY NOT BE ABLE TO SUCCESSFULLY EXPLOIT THE ACQUIRED PRODUCTS.

On July 31, 2006, we completed the acquisition of certain assets and liabilities of TelSoft, a California corporation, a provider of call accounting and TEM solutions. The acquisition of TelSoft's TEM and call accounting software enables us to expand our TEM solutions and assists us to strengthen our growing business in the United States. We may not be able to successfully integrate the operations of TelSoft into our business or successfully exploit the solutions that we acquired from it.

WE FACE RISKS ASSOCIATED WITH EXPANDING AND MAINTAINING OUR DISTRIBUTION NETWORK.

We sell our products through distributors, business telephone switching systems manufacturers and vendors, post, telephone and telegraph authorities, or PTTs and our direct sales force. Our ability to achieve revenue growth in the future will depend in large part on our success in establishing and maintaining relationships with business telephone switching systems manufacturers and vendors and PTTs, and establishing and maintaining relationships with distributors. Historically, we have at times experienced difficulty in establishing effective distribution relationships. We may not be able to successfully expand our distribution channels or any such expansion may not result in an increase in revenues. The failure to expand or maintain our distribution channels could have a material adverse effect on our business, operating results and financial condition.

WE ARE SUBJECT TO RISKS ASSOCIATED WITH INTERNATIONAL OPERATIONS.

We are based in Israel and generate a large percentage of our sales outside the United States. Our sales in the United States accounted for 52.0%, 51.1% and 52.7% of our total revenues for the years ended December 31, 2005, 2006 and 2007, respectively. We may not be able to maintain or increase international

market demand for our products. To the extent that we cannot do so in a timely manner, our business, operating results and financial condition will be materially and adversely affected.

International operations are subject to inherent risks, including the following:

- the impact of possible recessionary environments in multiple foreign markets;
- costs of localizing products for foreign markets;
- longer receivables collection periods and greater difficulty in accounts receivable collection;
- unexpected changes in regulatory requirements;
- difficulties and costs of staffing and managing foreign operations;
- reduced protection for intellectual property rights in some countries;
- potentially adverse tax consequences; and
- political and economic instability.



Our distributors or resellers may not be able to sustain or increase revenues from international operations or the foregoing factors may have a material adverse effect on our future revenues and, as a result, on our business, operating results and financial condition.

We may be adversely affected by fluctuations in currency exchange rates. While our revenues are generally denominated in U.S. dollars and Euros, a significant portion of our expenses are incurred in NIS. We do not currently engage in any currency hedging transactions intended to reduce the effect of fluctuations in foreign currency exchange rates on our results of operations. If we were to determine that it was in our best interests to enter into any hedging transactions in the future, we may not be able to do so or such transactions, if entered into, may not materially reduce the effect of fluctuations in foreign currency exchange rates on our results of operations. In addition, if, for any reason, exchange or price controls or other restrictions on the conversion of foreign currencies into NIS were imposed, our business could be adversely affected. Currency fluctuations in the future may have a material adverse effect on revenues from international sales and, consequently, on our business, operating results and financial condition.

WE ARE SUBJECT TO RISKS RELATING TO PROPRIETARY RIGHTS AND RISKS OF INFRINGEMENT.

We are dependent upon our proprietary software technology and we rely primarily on a combination of copyright and trademark laws, trade secrets, confidentiality procedures and contractual provisions to protect our proprietary rights. We try to protect our software, documentation and other written materials under trade secret and copyright laws, which afford only limited protection. It is possible that others will develop technologies that are similar or superior to our technology. Unauthorized parties may attempt to copy aspects of our products or to obtain and use information that we regard as proprietary. It is difficult to police the unauthorized use of our products, and

we expect software piracy to be a persistent problem, although we are unable to determine the extent to which piracy of our software products exists. In addition, the laws of some foreign countries do not protect our proprietary rights as fully as do the laws of the United States. Our means of protecting our proprietary rights in the United States or abroad may not be adequate or our competition may independently develop similar technology.

We are not aware that we are infringing upon any proprietary rights of third parties. However, it is possible, that third parties will claim infringement by us of their intellectual property rights. We believe that software product developers will increasingly be subject to infringement claims as the number of products and competitors in our industry segment grows and the functionality of products in different industry segments overlaps. It would be time consuming for us to defend any such claims, with or without merit, and any such claims could:

- result in costly litigation;
- divert management's attention and resources;
- cause product shipment delays; or
- require us to enter into royalty or licensing agreements. Such royalty or licensing agreements, if required, may not be available on terms acceptable to us, if at all.

If there is a successful claim of product infringement against us and we are not able to license the infringed or similar technology, our business, operating results and financial condition would be materially and adversely affected.

We rely upon certain software that we license from third parties, including software that we integrate with our internally developed software. These third-party software licenses may not continue to be available to us on commercially reasonable terms. If we lose or are unable to maintain any such software licenses, we could suffer shipment delays or reductions until equivalent software could be developed, identified, licensed and integrated, which would materially and adversely affect our business, operating results and financial condition.



WE MAY BE UNSUCCESSFUL IN OUR DEFENSE OF PENDING LITIGATION.

In April 2000, the tax authorities in Israel issued a demand for a tax payment for the 1997-1999 period in the amount of approximately NIS 6.0 million ($1.6 million). We have appealed to the Israeli District Court in respect of such tax demand and believe that certain defenses can be raised against the demand of the tax authorities. We have made a provision in our financial statements for this tax demand for the amount deemed probable.

If we are unsuccessful in the above and other pending claims and litigations or if actual results are not consistent with our assumptions and judgments, we may be exposed to losses that could be material to our company.

OUR RESULTS MAY BE ADVERSELY AFFECTED BY COMPETITION.

The market for telemanagement products and invoice management solutions is fragmented and is intensely competitive. Competition in the industry is

generally based on product performance, depth of product line, technical support and price. We compete both with international and local competitors (including providers of telecommunications services), many of whom have significantly greater financial, technical and marketing resources than us. We anticipate continuing competition in the telemanagement products and invoice management solution market and the entrance of new competitors into the market. Our existing and potential customers, including business telephone switching system manufacturers and vendors, may be able to develop telemanagement products and services that are as effective as, or more effective or easier to use than, those offered by us. Such existing and potential competitors may also enjoy substantial advantages over us in terms of research and development expertise, manufacturing efficiency, name recognition, sales and marketing expertise and distribution channels. We may not be able to compete successfully against current or future competitors and that competition may have a material adverse effect on our future revenues and, consequently, on our business, operating results and financial condition.

WE ARE SUBJECT TO RISKS ASSOCIATED WITH RAPID TECHNOLOGICAL CHANGE AND RISKS ASSOCIATED WITH NEW VERSIONS AND NEW PRODUCTS.

The information and telecommunication service providers market in which we compete is characterized by rapid technological change, introductions of new products, changes in customer demands and evolving industry standards. Our future success will depend upon our ability to keep pace with the technological developments and to timely address the increasingly sophisticated needs of our customers by supporting existing and new telecommunication technologies and services and by developing and introducing enhancements to our current and new products. We may not be successful in developing and marketing enhancements to our products that will respond to technological change, evolving industry standards or customer requirements, we may experience difficulties that could delay or prevent the successful development, introduction and sale of such enhancements or such enhancements may not adequately meet the requirements of the marketplace and achieve any significant degrees of market acceptance. If release dates of any new products or enhancements are delayed or, if when released, they fail to achieve market acceptance, our business, operating results and financial condition would be materially and adversely affected. In addition, the introduction or announcement of new product offerings or enhancements by us or our competitors may cause customers to defer or forgo purchases of current versions of our product, which could have a material adverse effect on our business, operating results and financial condition.

WE MAY NOT BE ABLE TO RETAIN OR ATTRACT KEY MANAGERIAL, TECHNICAL AND RESEARCH AND DEVELOPMENT PERSONNEL WE NEED TO SUCCEED.

Our success has largely depended and will depend in the future on our skilled professional and technical employees. The competition for these employees is intense. We may not be able to retain our present employees, or recruit additional qualified employees as we require them. The loss of any key member of our management team might significantly delay or prevent the achievement of our business or development objectives. Our ability to replace key members of our management team and hire additional skilled personnel in the future might be negatively impacted by the use of restrictive covenants in our industry and market. Any failure to attract and retain key managerial, technical and research and development personnel could have a material adverse affect on our ability to generate sales, deploy our products or successfully develop new products and enhancements.

FOUR OF OUR SHAREHOLDERS ARE IN A POSITION TO CONTROL MATTERS REQUIRING A SHAREHOLDER VOTE.

Mr. Chaim Mer, our Chairman, and his wife, Dora Mer, our Israeli counsel, currently control the vote of approximately 31.0% of our outstanding ordinary shares, Isaac Ben-Bassat, one of our directors, is the owner of 10.6% of our outstanding ordinary shares, and Lior Salansky, our President, is the owner of 16.1% of our outstanding ordinary shares. As a result, such persons control and will continue to control the election of our entire Board of Directors other than our three outside directors and generally have the ability to direct our business and affairs.

WE ARE SUBJECT TO RISKS ARISING FROM PRODUCT DEFECTS AND POTENTIAL PRODUCT LIABILITY.

We provide free warranty and support for up to one year for end-users and up to 15 months for our OEM distributors. Our sales agreements typically contain provisions designed to limit our exposure to potential product liability or related claims. The limitation of liability provisions contained in our agreements may not be effective. Our products are used by businesses to reduce communication costs, recover charges payable by third parties, prevent abuse and misuse of telephone networks and converged billing solutions for information and telecommunication service providers, and as a result, the sale of products by us may entail the risk of product liability and related claims. A product liability claim brought against us could have a material adverse effect upon our business, operating results and financial condition. Products such as those offered by us may contain undetected errors or failures when first introduced or when new versions are released. Despite our testing and testing by current and potential customers, errors may be found in new products or releases after commencement of commercial shipments. The occurrence of these errors could result in adverse publicity, loss of or delay in market acceptance or claims by customers against us, any of which could have a material adverse effect upon our business, operating results and financial condition.

WE ARE NOT IN COMPLIANCE WITH CERTAIN FINANCIAL COVENANTS AND MAY NOT BE ABLE TO OBTAIN OR MAINTAIN COMPLIANCE WITH THOSE FINANCIAL COVENANTS IN THE FUTURE

On July 27, 2006, we obtained a $1.0 million loan from Bank Hapoalim in order to facilitate the funding of the TelSoft acquisition. We have made monthly repayments under the loan agreement and had an outstanding balance of $583,000 as of December 31, 2007. Under the terms of the loan, we are required to maintain (i) shareholders' equity of not less than $5 million and 40% of our total assets; (ii) operating profit over two consecutive quarters as of the second quarter of 2007; and (iii) cash and cash equivalents of not less than $1 million. As a security interest for the repayment of the loan, we agreed to grant Bank Hapoalim a floating-charge over all of our company's assets, a fixed charge over our company's share capital, goodwill and rights to an exemption from taxation or reduced tax, and a fixed charge over all of the securities, documents and notes in the possession of Bank Hapoalim. We are not currently in compliance with such covenants and may not be able to achieve or maintain compliance with those financial covenants in the future.

RISK FACTORS RELATED TO OUR ORDINARY SHARES

IF WE FAIL TO MAINTAIN NASDAQ'S CONTINUED LISTING REQUIREMENT OF MINIMUM SHAREHOLDERS' EQUITY OF $2.5 MILLION, OUR SHARES MAY BE IMMEDIATELY DELISTED FROM THE NASDAQ CAPITAL MARKET.

Our ordinary shares are listed on The NASDAQ Capital Market under the symbol MTSL. To continue to be listed on NASDAQ, we need to satisfy a number of conditions, including minimum shareholders' equity of at least $2.5 million. We fell below the minimum $2.5 million shareholders' equity in third quarter of

2007. The Staff determined to delist our shares as of December 31, 2007 unless we chose to appeal. We appealed the Staff' decision and on March 17, 2008, we received notice that the NASDAQ Hearings Panel had determined to continue the listing of our ordinary shares, subject to certain conditions, including that by May 16, 2008, we file with the Securities and Exchange Commission and with NASDAQ a Form 6-K that includes financial statements for the quarter ending March 31, 2008 and demonstrate more than $2.5 million in actual (not pro forma) shareholders' equity. If we fail to satisfy such condition, our shares will be delisted. If we meet such condition, the Panel will find that we are in compliance with the shareholders' equity requirement and will impose a Panel Monitor. Under the Panel Monitor, our continued listing is conditioned upon us filing, within 45 days of the end of each fiscal quarter ending on or before March 31, 2009, a Form 6-K with the Securities and Exchange Commission and NASDAQ that includes financial statements for the prior quarter and demonstrates compliance with the $2.5 million minimum shareholder's equity continued listing requirement. If we fail to demonstrate shareholders' equity of $2.5 million or greater, the Panel will review the matter and our shares may be immediately delisted. If we are delisted from NASDAQ, trading in our ordinary shares would be conducted on a market where an investor would likely find it significantly more difficult to dispose of, or to obtain accurate quotations as to the value of, our ordinary shares.



WE MAY IN THE FUTURE BE CLASSIFIED AS A PASSIVE FOREIGN INVESTMENT COMPANY, OR PFIC, WHICH WILL SUBJECT OUR U.S. INVESTORS TO ADVERSE TAX RULES.

Holders of our ordinary shares who are United States residents face income tax risks. There is a substantial risk that we may become a passive foreign investment company, commonly referred to as PFIC. Our treatment as a PFIC could result in a reduction in the after-tax return to the holders of our ordinary shares and would likely cause a reduction in the value of such shares. For U.S. Federal income tax purposes, we will be classified as a PFIC for any taxable year in which either (i) 75% or more of our gross income is passive income, or (ii) at least 50% of the average value of all of our assets for the taxable year produce or are held for the production of passive income. For this purpose, cash is considered to be an asset, which produces passive income. As a result of our relatively substantial cash position at the time, we believe that we were a PFIC in certain periods over the last few years under a literal application of the asset test described above, which looks solely to the market value of our assets. We do not believe that we were a PFIC in 2007. If we are classified in the future as a PFIC for U.S. federal income tax purposes, highly complex rules would apply to U.S. Holders owning ordinary shares. Accordingly, you are urged to consult your tax advisors regarding the application of such rules.

OUR SHARE PRICE HAS BEEN VOLATILE IN THE PAST AND MAY DECLINE IN THE FUTURE.

Our ordinary shares have experienced significant market price and volume fluctuations in the past and may experience significant market price and volume fluctuations in the future in response to factors such as the following, some of which are beyond our control:

- quarterly variations in our operating results;
- operating results that vary from the expectations of securities analysts and investors;
- changes in expectations as to our future financial performance, including financial estimates by investors;

- announcements of technological innovations or new products by us or our competitors;
- announcements by us or our competitors of significant contracts, acquisitions, strategic partnerships, joint ventures or capital commitments;
- announcements by third parties of significant claims or proceedings against us;
- changes in the status of our intellectual property rights;
- additions or departures of key personnel;
- future sales of our ordinary shares; and



- general stock market prices and volume fluctuations.

Domestic and international stock markets often experience extreme price and volume fluctuations. Market fluctuations, as well as general political and economic conditions, such as a recession or interest rate or currency rate fluctuations or political events or hostilities in or surrounding Israel, could adversely affect the market price of our ordinary shares.

In the past, securities class action litigation has often been brought against a company following periods of volatility in the market price of its securities. We may in the future be the target of similar litigation. Securities litigation could result in substantial costs and divert management's attention and resources.

WE DO NOT EXPECT TO DISTRIBUTE CASH DIVIDENDS.

We do not anticipate paying cash dividends in the foreseeable future. According to the Israeli Companies Law, a company may distribute dividends out of its profits (within the meaning of the Israeli Companies Law), so long as the company reasonably believes that such dividend distribution will not prevent the company from paying all its current and future debts. The declaration of dividends is subject to the discretion of our Board of Directors and will depend on various factors, including our operating results, financial condition, future prospects and any other factors deemed relevant by our board of directors. You should not rely on an investment in our company if you require dividend income from your investment in our company. The success of your investment will likely depend entirely upon any future appreciation of the market price of our ordinary shares, which is uncertain and unpredictable. There is no guarantee that our ordinary shares will appreciate in value or even maintain the price at which you purchased your ordinary shares.

WE MAY FAIL TO MAINTAIN EFFECTIVE INTERNAL CONTROLS IN ACCORDANCE WITH SECTION 404 OF THE SARBANES-OXLEY ACT OF 2002.

The Sarbanes-Oxley Act of 2002 imposes certain duties on us and our executives and directors. Our efforts to comply with the requirements of Section 404 of the Sarbanes-Oxley Act of 2002 governing internal controls and procedures for financial reporting, which started in connection with this Annual Report on Form 20-F, have resulted in increased general and administrative expense and a diversion of management time and attention, and we expect these efforts to

require the continued commitment of significant resources. We may identify material weaknesses or significant deficiencies in our assessments of our internal controls over financial reporting. Failure to maintain effective internal controls over financial reporting could result in investigation or sanctions by regulatory authorities and could have a material adverse effect on our operating results, investor confidence in our reported financial information and the market price of our ordinary shares.

RISKS RELATING TO OPERATIONS IN ISRAEL

POLITICAL, ECONOMIC AND MILITARY INSTABILITY IN ISRAEL MAY DISRUPT OUR OPERATIONS AND NEGATIVELY AFFECT OUR BUSINESS CONDITION, HARM OUR RESULTS OF OPERATIONS AND ADVERSELY AFFECT OUR SHARE PRICE.

We are incorporated under the laws of, and our principal executive offices and manufacturing and research and development facilities are located in, the State of Israel. As a result, political, economic and military conditions affecting Israel directly influence us. Any major hostilities involving Israel, a full or partial mobilization of the reserve forces of the Israeli army, the interruption or curtailment of trade between Israel and its present trading partners, or a significant downturn in the economic or financial condition of Israel could have a material adverse effect on our business, financial condition and results of operations.



Since the establishment of the State of Israel in 1948, Israel and its Arab neighbors have engaged in a number of armed conflicts. A state of hostility, varying from time to time in intensity and degree, has led to security and economic problems for Israel. Major hostilities between Israel and its neighbors may hinder Israel's international trade and lead to economic downturn. This, in turn, could have a material adverse effect on our operations and business. There has been an increase in unrest and terrorist activity in Israel, which began in September 2000 and which has continued with varying levels of severity through 2007. The future effect of this deterioration and violence on the Israeli economy and our operations is unclear. Recently, there was an escalation in violence among Israel, Hamas, the Palestinian Authority and other groups, as well as extensive hostilities along Israel's northern border with Lebanon in the summer of 2006, and extensive hostilities along Israel's border with the Gaza Strip since June 2007 when the Hamas effectively took control of the Gaza Strip. Ongoing violence between Israel and the Palestinians as well as tension between Israel and the neighboring Syria and Lebanon may have a material adverse effect on our business, financial conditions and results of operations.

Furthermore, there are a number of countries, primarily in the Middle East, as well as Malaysia and Indonesia, that restrict business with Israel or Israeli companies, and we are precluded from marketing our products to these countries. Restrictive laws or policies directed towards Israel or Israeli businesses may have an adverse impact on our operations, our financial results or the expansion of our business.

OUR RESULTS OF OPERATIONS MAY BE NEGATIVELY AFFECTED BY THE OBLIGATION OF OUR PERSONNEL TO PERFORM MILITARY SERVICE.

Some of our directors, officers and employees in Israel are obligated to perform annual reserve duty in the Israeli Defense Forces and may be called for active duty under emergency circumstances at any time. If a military conflict or war arises, these individuals could be required to serve in the military for extended periods of time. Our operations could be disrupted by the absence for a

significant period of one or more of our executive officers or key employees or a significant number of other employees due to military service. Any disruption in our operations could adversely affect our business.

OUR FINANCIAL RESULTS MAY BE ADVERSELY AFFECTED BY INFLATION AND CURRENCY FLUCTUATIONS.

We report our financial results in dollars, while a significant amount of our expenses, primarily salaries, are paid in NIS. Therefore, our NIS related costs, as expressed in U.S. dollars, are influenced by the exchange rate between the U.S. dollar and the NIS. During 2007, the NIS appreciated against the U.S. dollar, which resulted in a significant increase in the U.S. dollar cost of our NIS expenses. Such trend continued during the first three months of 2008 with further devaluation of the U.S. dollar compared to the NIS. We are also influenced by the timing of, and the extent to which, any increase in the rate of inflation in Israel over the rate of inflation in the United States is not offset by the devaluation of the NIS in relation to the dollar. Our dollar costs in Israel will increase if inflation in Israel exceeds the devaluation of the NIS against the dollar or if the timing of such devaluation lags behind inflation in Israel. In the past, the NIS has devalued against the dollar and other foreign currencies, generally reflecting inflation rate differentials. We cannot predict any future trends in the rate of inflation in Israel or the rate of devaluation or appreciation of the NIS against the dollar. If the dollar cost of our operations in Israel increases, our dollar measured results of operations will be adversely affected. Likewise, our operations could be adversely affected if we are unable to guard against currency fluctuations in the future.

THE GOVERNMENT PROGRAMS AND TAX BENEFITS WE CURRENTLY PARTICIPATE IN OR RECEIVE REQUIRE US TO MEET SEVERAL CONDITIONS AND MAY BE TERMINATED OR REDUCED IN THE FUTURE.

We have benefited from certain Israeli Government grants, programs and tax benefits. In late 2005 and early 2006 and 2007, we applied to the Office of the Chief Scientist of the Israeli Ministry of Industry, Trade and Labor for grants for our research and development projects and we subsequently received approval such applications. Future grant applications may not be approved by the Office of the Chief Scientist and we may not be able to obtain any such grants in the future. To remain eligible for these grants, programs and tax benefits, we must comply with certain conditions, including making specified investments in fixed assets from our own equity and paying royalties with respect to grants received. In addition, some of these programs restrict our ability to manufacture particular products and to transfer particular technology outside of Israel. If we do not meet these conditions in the future, the benefits we received could be canceled and we may have to refund payments previously received under these programs or pay increased taxes. The Government of Israel has reduced the benefits available under these programs in recent years and these programs and tax benefits may be discontinued or curtailed in the future.



SERVICE AND ENFORCEMENT OF LEGAL PROCESS ON US AND OUR DIRECTORS AND OFFICERS MAY BE DIFFICULT TO OBTAIN.

Service of process upon our directors and officers and the Israeli experts named herein, most of whom reside outside the United States, may be difficult to obtain within the United States. Furthermore, since substantially all of our assets, most of our directors and officers and the Israeli experts named herein are located outside the United States, any judgment obtained in the United States against us or these individuals or entities may not be collectible within

the United States.

There is doubt as to the enforceability of civil liabilities under the Securities Act and the Securities Exchange Act in original actions instituted in Israel. However, subject to certain time limitations and other conditions, Israeli courts may enforce final judgments of United States courts for liquidated amounts in civil matters, including judgments based upon the civil liability provisions of those Acts.

PROVISIONS OF ISRAELI LAW MAY DELAY, PREVENT OR MAKE DIFFICULT OUR ACQUISITION BY A THIRD-PARTY, WHICH COULD PREVENT A CHANGE OF CONTROL AND THEREFORE DEPRESS THE PRICE OF OUR SHARES.

Provisions of Israeli corporate and tax law may have the effect of delaying, preventing or making more difficult a merger with, or other acquisition of, us. This could cause our ordinary shares to trade at prices below the price for which third parties might be willing to pay to gain control of us. Third parties who are otherwise willing to pay a premium over prevailing market prices to gain control of us may be unable or unwilling to do so because of these provisions of Israeli law.

THE RIGHTS AND RESPONSIBILITIES OF OUR SHAREHOLDERS ARE GOVERNED BY ISRAELI LAW AND DIFFER IN SOME RESPECTS FROM THE RIGHTS AND RESPONSIBILITIES OF SHAREHOLDERS UNDER U.S. LAW.

We are incorporated under Israeli law. The rights and responsibilities of holders of our ordinary shares are governed by our memorandum of association, articles of association and Israeli law. These rights and responsibilities differ in some respects from the rights and responsibilities of shareholders in typical U.S. corporations. In particular, each shareholder of an Israeli company has a duty to act in good faith in exercising his or her rights and fulfilling his or her obligations toward the company and other shareholders and to refrain from abusing his power in the company, including, among other things, in voting at the general meeting of shareholders on certain matters. Israeli law provides that these duties are applicable in shareholder votes on, among other things, amendments to a company's articles of association, increases in a company's authorized share capital, mergers and interested party transactions requiring shareholder approval. In addition, a controlling shareholder of an Israeli company or a shareholder who knows that it possesses the power to determine the outcome of a shareholder vote or who has the power to appoint or prevent the appointment of a director or officer in the company has a duty of fairness toward the company. However, Israeli law does not define the substance of this duty of fairness. Because Israeli corporate law has undergone extensive revision in recent years, there is little case law available to assist in understanding the implications of these provisions that govern shareholder behavior.

AS A FOREIGN PRIVATE ISSUER WHOSE SHARES ARE LISTED ON THE NASDAQ CAPITAL MARKET, WE MAY FOLLOW CERTAIN HOME COUNTRY CORPORATE GOVERNANCE PRACTICES INSTEAD OF CERTAIN NASDAQ REQUIREMENTS.

As a foreign private issuer whose shares are listed on the NASDAQ Capital Market, we are permitted to follow certain home country corporate governance practices instead of certain requirements of the NASDAQ Marketplace Rules, including the composition of our Board of Directors, director nomination procedure, compensation of officers, distribution of annual reports to shareholders and quorum at shareholders meetings. In addition, we may follow Israeli law instead of the NASDAQ Marketplace Rules that require that we obtain shareholder approval for certain dilutive events, such as for the establishment or amendment of certain equity based compensation plans, an issuance that will result in a change of control of our company, certain transactions other than a public offering involving issuances of a 20% or more interest in our company and certain acquisitions of the stock or assets of another company. Currently, we

follow Israeli law and practice instead of the NASDAQ requirements with respect to the directors' nomination process.



ITEM 4. INFORMATION ON THE COMPANY

A. HISTORY AND DEVELOPMENT OF THE COMPANY

Our company was incorporated under the laws of the State of Israel in December 1995. We are a public limited liability company under the Israeli Companies Law 5739-1999 and operate under such law and associated legislation. Our registered offices and principal place of business are located at 22 Zarhin Street, Ra'anana 43662, Israel, and our telephone number is +972-9-762-1777. Our address on the Internet Is www.mtsint.com. The information on our website is not incorporated by reference into this annual report.

We are a worldwide provider of solutions for telecommunications expense management, or TEM, and billing solutions. Our TEM solutions assist enterprises and organizations to make smarter choices with their telecommunications spending at each stage of the service lifecycle, including allocation of cost, proactive budget control, fraud detection, processing of payments and spending forecasting. Our converged billing solutions have been successfully implemented worldwide by wireless providers, Voice over Internet Protocol, Internet Protocol Television, and content service providers. Our converged billing solutions include applications for charging and invoicing customers, interconnect billing and partner revenue management using pre-pay and post-pay schemes.

In December 2004, we completed the acquisition of certain assets and liabilities of Teleknowledge Group Ltd., or Teleknowledge, a provider of carrier class billing and related solutions. In connection with the acquisition, we paid an initial consideration of $2.4 million in cash and agreed to pay additional contingent consideration of up to $3.6 million over a period of three years based on post acquisition revenue performance. We acquired the Teleknowledge billing solution in order to be able to offer an end-to-end customer care and billing solution, including pre/post paid billing, web self-care, assets management, partner management, help desk and order management modules. During the first six months of 2007, we determined that the goodwill and intangible assets relating to the acquisition of the Teleknowledge billing activity in the amount of approximately $2.3 million had been impaired and the carrying value was written off.

During 2005, we conducted extensive research and development so that our products and solutions could operate in the high-end enterprise market. As a result, an advanced TEM module was developed, based on our Application Suite infrastructure. The modular and scalable architecture topology of our Application SUITE lends itself easily to an open platform where modules can be added and integrated seamlessly into the platform, thus allowing customers to buy such modules as they require. In addition, in 2005 we strengthened our product offerings to the service provider and carrier market as a result of our release of a new billing solution module that we acquired from Teleknowledge and through significant investment in research and development in order to provide a complete end-to-end billing solution for the wholesale trade. As a result, we introduced an interconnect billing solution and our retail billing solution was expanded to accommodate legacy telephony that carriers can use to bill their subscribers. Also, new value-added services (such as video-on-demand (VOD), multimedia message service, short message service (SMS)) and content (such as news and games) were added to our billing solutions package. We believe that an advantage of our solutions is that they operate off a single data base. We also

introduced a partner revenue management module to our billing solutions product, which complements our product line by enabling carriers to reconcile bills among one another.

During 2006, we enhanced our interconnect billing solution to include a sophisticated and user-friendly rate loader, that automatically loads the rates from the various Excel sheets that service providers receive and provides a composite picture of the rates. In 2006, we also developed solutions for mobile phones based on a patent for which we have filed an international patent application (PCT application),which is currently pending, to track and account for calls made from a mobile phone. One of the solutions provides for reconciliation of calls made from a mobile phone independent of the service provider and is intended for enterprises to check and monitor calls made from mobile phones of their employees. Another solution, Wireless Leak Detector, is intended for service providers to ascertain that all calls made from a mobile phone have been accounted for and charged.



Another development in 2006 was the introduction of our Invoice Management solution that allows tracking of vendors, invoices, assets and contracts both for pricing and maintenance, with the ultimate objective of reconciling the invoices for payment or dispute. The solution can be purchased by an enterprise for their own accounting, or outsourced as an Application Service Provider (ASP).

On July 31, 2006, we completed the acquisition of certain assets and liabilities of TelSoft, California based provider of call accounting products. We believe that the acquisition of TelSoft's call accounting software have enabled us to expand our business in the United States. In connection with the acquisition, we paid an initial consideration of $1.1 million and agreed to pay additional contingent consideration based on post acquisition revenue performance during the 12 month period following the acquisition. As of December 31, 2007, based on the post acquisition revenue performance during the 12 month period following the acquisition, we have recorded an aggregate $606,000 of additional contingent consideration, of which $200,000 was paid in 2007 and the balance was paid during the first quarter of 2008.

In November 2007, we completed the sale of our 50% ownership interest in Jusan S.A., our Spanish affiliate, in consideration of 700,000 Euros (approximately $1.0 million) plus the payment to us of 25% of the net income, if any, of Jusan S.A. during the period commencing upon completion of the sale and ending June 30, 2008. We recorded an equity loss of $197,000 as a result of the transaction.

In December 2007, we received notice that Online Media Solutions Ltd., a privately-owned leading online advertising company, in which we held approximately a 1% ownership interest, was sold to a third party. We received total proceeds of approximately $36,000 from the sale. We recorded a capital loss of $63,000 as a result of the transaction.

In February 2008, we completed the sale of our ownership interest in cVidya Networks Inc. and received total proceeds of approximately $603,000 for the sale. We will record a capital gain of approximately $382,000 as a result of the transaction in 2008.

B. BUSINESS OVERVIEW

INDUSTRY BACKGROUND

Technological advances and worldwide deregulation and privatization in the telecommunications industry have resulted in the growth of alternative telecommunication services providers, such as cellular companies, competitive access providers, cable companies and data transmission companies. This growth, in conjunction with dramatic improvements in computing and communications technology, including the convergence of telephony systems and computers, or computer telephony integration, has fostered the rapid expansion of communication services and an increase in the volume of voice and data traffic by business organizations. The diversification of services and providers using varied pricing algorithms and the proliferation of domestic and international networks using varied equipment and technologies for different services and modes of transmission has placed new demands on telecommunication and information technology managers and has created the need for sophisticated and flexible telecommunication management solutions. This has created a demand for telemanagement solutions that are capable of supporting multiple sites, switching platforms, languages and currencies, as well as the generation of telecommunications usage information vital to an enterprise's operations.

Telemanagement solutions have evolved from the stand-alone PC-based telephone call accounting and billing systems of the mid-1980's to local area network or LAN-based systems offering call accounting, fraud detection and fault management solutions for users with complex voice and data networks. Over the years, telemanagement solutions have expanded to support information technology, or IT, and telecom activities, such as the management of IT assets, an enterprise's internal billing processes, system modifications and enterprise help desks.



Call accounting products, a fundamental management tool, record, retrieve and process data received from a PBX or other telephone switching system, providing a telecommunications manager with information on telephone usage. This information enables the management of internal billing, fraud detection and optimizes the telecommunications resources.

With today's greater mobility, the need to keep track of moves and changes in an organization requires the use of tools to control, manage and document these changes more effectively. The useful life of a standard cabling structure should be 15 years. This means that existing cables should be able to support an average of three upgrades of communication equipment during its lifetime, plus an average of five changes to all outlets. It is virtually impossible to achieve this performance level without maintaining accurate records reflecting all details of cabling installations.

The continuing increase in use of cellular phones for business, during and outside working hours, has created the need to develop products that will enable an enterprise to generate a true and full record of all the calls made by its employees, including cellular calls and calls made by calling cards and other charge plans.

Telephony over the Internet, which provides voice communications using the Internet, is now becoming more prevalent. In conjunction with these services is "pre-paid", which allows a customer to buy a certain amount of time (expressed as a function of money) either from the web or through the purchase of a "scratch" card (which contains an account or personal identification number (PIN) and units of time) and debits the account with each usage.

Internet Protocol Television, or IPTV, digital television service delivered

using the Internet Protocol over a network infrastructure, is also becoming more prevalent. For IPTV services, billing solutions are required to be able to offer and charge personalized rates, such as rate per content attributes, bundled package discounts and advice-of-charge according to subscriber's attributes before a service is consumed. In addition, since IPTV service providers rely heavily on revenues from direct advertising and charge the advertiser by exposures and per click, a billing solution for IPTV must be able to identify such events and charge the advertiser accordingly.

PRODUCTS AND SERVICES

CALL ACCOUNTING AND TELECOMMUNICATIONS EXPENSE MANAGEMENT SOLUTIONS FOR ENTERPRISES

TABS.IT

TABS.IT is a solution for small offices, medium sized businesses and Fortune 500 enterprises that want to take full control over their communications network. Specific applications enable hotels, shared tenant environments, hospitals, universities and service bureaus to resell communications services to users employing simple, yet efficient mark-up formulas.

TABS.IT tracks the details of all voice communications usage (such as dialed numbers, call duration, destination, cost of each call and trunk line usage) and produces accurately priced individual customer bills. In addition, TABS.IT tracks the details of all data communications (such as IP address, name, number of bytes, bandwidth usage and nodes) and can produce a relative cost figure.

The TABS.IT report generator provides a wide variety of usage reports that are easy to read and understand, yet provide all the information necessary to identify how communications network resources are being utilized. These reports can be generated either as a summary of the call data or complete with all the details necessary to make informed management decisions. Their structural flexibility allows the user to quickly zero in on the specific data of greatest interest. Historical reports may be maintained for an unlimited period of time and can become useful tools for assessing budget needs for the coming months or years.



APPLICATION SUITE

The Application Suite is a set of applications that assist in the management of telecom activities and the IT manager's activities. The system enables organizations to effectively manage their entire internal billing process. Utilizing its web-based user centric capabilities, the platform provides its users, including administrators, employees and customers, with a single easy-to-use interface self provisioning customer care, while guaranteeing corporate security via the different authentication levels.

Application Suite includes an invoice management module, which checks the rates billed by the service provider against the contracted rates and also reconciles an organization's telecommunications bills, reflecting the usage reported by the service provider with the actual usage recorded by the Application Suite. Additionally, the invoice management module checks that the service provider has charged only for communication equipment actually used by the organization, as opposed to equipment that is no longer serviceable or not under current service contracts. An organization's internal procedures for payment of bills can be entered into the Application Suite and it will track the

bills and insure that there are no delays in payments, and in the case of discrepancies between the usage and bills, it will provide an analysis of the discrepancies.

Application Suite includes a workflow and provisioning module that enables the management of an organization's process. The provisioning capability enables the performance of changes in the IT and telecom network as part of the process and saves time and reduces security risks as a result.

BILLING SOLUTIONS

Our billing solution for service providers is based on Total-e product with the following modules:

- Retail Billing - customer care and billing (business and residential). The billing and rating is for both postpaid and prepaid scenarios.

- Partner Management - management of all value added services, or VAS, provided (such as content SMS/MMS, pay-by-mobile services and location-based advertising services). The module supports advance business models, such as revenue sharing between the operator/service provider and VAS provider based on the end customer's consumption.

- Interconnect/Wholesale Management - manages the activity between the operator/service provider and other local or international carriers for the traffic that is transferred between them. The basic goal of an interconnect solution is to produce an invoice for the calls you have delivered for another operator and to validate the invoices received from other operators for the calls they have delivered for you.

Our billing solution for IPTV may be installed side-by-side with legacy systems and may provide an economic solution to new providers of virtual IPTV services. Based on our experience to date, our billing solutions for IPTV meets the emerging market requirements for IPTV billing solutions.

CUSTOMER SERVICE AND INSTALLATION

We provide customer support to end-users and channels (distributors and business partners) in the United States, Israel, Hong Kong and Brazil on both a service contract and a per-incident basis. Our technical support engineers answer support calls directly and generally seek to provide same-day responses. We provide updated telephone rate tables to customers on a periodic basis under annual service contracts. The rate tables are obtained from third-party vendors who provide this data for all major long-distance service providers. Our distributors provide a full range of service and technical support functions for our products, including rate tables, to their respective end-user customers.



SALES AND MARKETING

We believe that partnering with network vendors and system integrators is the most advantageous means to generate new sales of our solutions. In addition, our broad base of previously installed solutions, primarily in the United States, provides us with opportunities to offer and sell any new products, solutions and services.

We sell our solutions worldwide through original equipment manufacturer, or OEM, distribution channels and our own direct sales force in the United States,

Israel, Hong Kong and Brazil, and through a network of local distributors in these and various other countries. We employed 12 persons in sales and marketing and 18 persons in support as of December 31, 2007, as compared to 20 persons in sales and marketing and 29 persons in support as of December 31, 2006.

We conduct a wide range of marketing activities aimed at generating awareness and leads. We maintain our website (www.mtsint.com), allowing for correspondence and queries from new potential customers as well as promoting support for our existing customer base.

MANAGED SERVICES

Our managed services solution is an outsourcing solution geared to multi-national companies that centrally manage their telecommunications usage and is offered as an added value service. This solution has been offered in the United States where our New Jersey office acts as a service bureau.

SWITCHING SYSTEMS MANUFACTURERS AND VENDORS. We believe that the most efficient means of selling our telemanagement products is to enter into relationships with major business telephone system manufacturers and vendors who market our products on either an OEM basis or supplemental sales basis at the time they sell their switching systems. We also utilize our distributors to market our products to local business telephone switching systems manufacturers and distributors. We intend to establish additional strategic relationships with business telephone switching systems manufacturers and vendors. Among the companies that sell our telemanagement products are Alcatel, Avaya, Damovo, ECI/Tadiran, Ericsson, Harris, LG, Lucent, Mitel, NEC, Nortel, Panasonic and Siemens. We have also entered into an agreement with a major global manufacturer with respect to our billing products. Sales attributable our largest OEM customer, Siemens, represented approximately 36.0%, 29.0, 26.4% of our total revenues for the years ended December 31, 2005, 2006 and 2007, respectively.

DISTRIBUTORS. In general, in those countries where we do not have a marketing subsidiary, we distribute our products through a local distributor. Marketing, sales, training, product and client support are provided by our local distributors. A local distributor is typically a telecommunication products marketing organization with the capability to add value with installation, training and support. Distributors are generally responsible for the localization of our products into their native language. The distributor also translates our standardized product marketing literature and technical documentation. Prior to becoming an authorized distributor, the distributor's employees must undergo sales and technical training. We are available for second-tier support for the distributor and for end-users. In coordination with the distributors, we also provide technical support for large and multinational accounts. We have distributors worldwide and intend to expand our network of distributors and resellers in selected markets.

STRATEGIC RELATIONSHIPS. As part of our marketing strategy, we attempt to develop and establish new strategic relationships with manufacturers of voice and data communication systems and IP-based equipment as means of entering new markets and channels.



COMPETITION

The market for telemanagement products and billing solutions is fragmented and intensely competitive. Competition in the industry is generally based on product performance, depth of product line, technical support and price. We

compete both with international and local competitors (including providers of telecommunications and billing services), many of whom have significantly greater financial, technical and marketing resources than we do. Our existing and potential customers, including business telephone switching system manufacturers and vendors, may be able to develop telemanagement and billing products and services that are as effective as, or more effective or easier to use than, those offered by us. Such existing and potential competitors may also enjoy substantial advantages over us in terms of research and development expertise, manufacturing efficiency, name recognition, sales and marketing expertise and distribution channels. Although we believe that the quality of our products is equal to or better than the product quality of our competitors with regard to performance and reliability, we have no quantitative data other than the evaluations of our present customers from which to assess our current ability to compete. There can be no assurance that we will be able to compete successfully against current or future competitors or that competition will not have a material adverse effect on our future revenues and, consequently, on our business, operating results and financial condition.

INTELLECTUAL PROPERTY RIGHTS

We rely upon a combination of security devices, copyrights, trademarks, patents, trade secret laws, confidentiality procedures and contractual restrictions to protect our rights in our products. In 2005, we filed an international patent application (PCT application), which is currently pending, relating to a mobile verification technique that verifies mobile phone usage against the bill received from the service provider. Our policy has been to pursue copyright protection for our software and related documentation and trademark registration of our product names. Some of our products have the added protection afforded by a hardware component which has embedded software that it is difficult to misappropriate. In addition, our key employees and independent contractors are required to sign non-disclosure and confidentiality agreements. All of the intellectual property rights with respect to our current products are held by Mer Telemanagement Solutions Ltd.

Our trademark rights include rights associated with the use of our trademarks and rights obtained by registration of our trademarks in Israel and the United States. We have also acquired rights in certain registered trademarks and common law trademarks and service marks in connection with the products we acquired from Teleknowledge in December 2004 and the assets we acquired from TelSoft in July 2006. The use and registration rights of our trademarks does not ensure that we have superior rights over other third parties that may have registered or used identical related marks on related goods or services. Trademark rights are territorial in nature; therefore we do not have rights in all jurisdictions.

We believe that, because of the rapid pace of technological change in the communication industry, the legal protections for our products are less significant factors in our success than the knowledge, ability and experience of our employees, the frequency of product enhancements and the timeliness and quality of support services provided by us.

C. ORGANIZATIONAL STRUCTURE

Our wholly-owned subsidiaries in the United States, Hong Kong, the Netherlands and Brazil, MTS IntegraTRAK Inc., MTS TelSoft Inc., MTS Asia Ltd., JARAGA B.V. and TABS Brazil Ltda., respectively, act as marketing and customer service organizations in those countries.

D. PROPERTY, PLANTS AND EQUIPMENT

Our executive offices and research and development facilities are located at 22 Zarhin Street, Ra'anana, Israel, where we occupy approximately 16,300

square feet. The lease, which expires on June 15, 2010, has an annual rental charge of approximately $450,000. We have subleased approximately 4,400 square feet of this space until June 15, 2010 for an annual rental charge of approximately $120,000.

Our U.S. subsidiary MTS IntegraTRAK Inc. occupies approximately 2,150 square feet of space in New Jersey, under a month-to-month lease for a monthly rental fee of $3,150. We have an office in Kirkland, Washington., where we occupy approximately 2,314 square feet. The lease, which expires on October 15, 2008, has a remaining obligation of approximately $45,000. We also have an office in Glendale, California, where we occupy approximately 2,340 square feet. of space. The lease is on a month-to-month basis for a monthly rental fee of approximately $5,300.



In addition, we lease offices in Hong Kong and Sao Paulo. The lease agreements for the Hong Kong and Sao Paulo offices will expire in October 2007 and August 2008, respectively and have a combined remaining obligation of approximately $32,000.

ITEM 4A. UNRESOLVED STAFF COMMENTS

Not applicable.

ITEM 5. OPERATING AND FINANCIAL REVIEW AND PROSPECTS

A. OPERATING RESULTS

THE FOLLOWING DISCUSSION OF OUR RESULTS OF OPERATIONS SHOULD BE READ TOGETHER WITH OUR AUDITED CONSOLIDATED FINANCIAL STATEMENTS AND THE RELATED NOTES, WHICH APPEAR ELSEWHERE IN THIS ANNUAL REPORT. THE FOLLOWING DISCUSSION CONTAINS FORWARD-LOOKING STATEMENTS THAT REFLECT OUR CURRENT PLANS, ESTIMATES AND BELIEFS AND INVOLVE RISKS AND UNCERTAINTIES. OUR ACTUAL RESULTS MAY DIFFER MATERIALLY FROM THOSE DISCUSSED IN THE FORWARD-LOOKING STATEMENTS. FACTORS THAT COULD CAUSE OR CONTRIBUTE TO SUCH DIFFERENCES INCLUDE THOSE DISCUSSED BELOW AND ELSEWHERE IN THIS ANNUAL REPORT.

BACKGROUND

We were incorporated under the laws of the State of Israel in December 1995, as a subsidiary of C.Mer Industries Ltd., an Israeli public company. Since our initial public offering in May 1997, our ordinary shares have been listed on the NASDAQ Stock Market. In June 1999, C.Mer Industries Ltd. distributed to its shareholders all of its remaining shares in our company as a dividend.

We have wholly-owned subsidiaries in the United States, Hong Kong, the Netherlands and Brazil, MTS IntegraTRAK Inc., MTS TelSoft Inc., MTS Asia Ltd., JARAGA B.V. and TABS Brazil Ltda., respectively, which act as marketing and customer service organizations in those countries.

OVERVIEW

We are a worldwide provider of solutions for telecommunications expense management, or TEM, and billing solutions. Our TEM solutions assist enterprises and organizations to make smarter choices with their telecommunications spending at each stage of the service lifecycle, including allocation of cost, proactive budget control, fraud detection, processing of payments and spending forecasting. Our converged billing solutions have been successfully implemented

worldwide by wireless providers, Voice over Internet Protocol, Internet Protocol Television, and content service providers. Our converged billing solutions include applications for charging and invoicing customers, interconnect billing and partner revenue management using pre-pay and post-pay schemes.

In November 2007, we completed the sale of our 50% ownership interest in Jusan S.A., our Spanish affiliate, in consideration of 700,000 Euros (approximately $1.0 million) plus the payment to us of 25% of the net income, if any, of Jusan S.A. during the period commencing upon completion of the sale and ending June 30, 2008 . We recorded an equity loss of $197,000 as a result of the transaction.

In December 2007, we received notice that Online Media Solutions Ltd., a privately-owned leading online advertising company, in which we held approximately a 1% ownership interest, was sold to a third party. We received total proceeds of approximately $36,000 from the sale. We recorded a capital loss of $63,000 as a result of the transaction.

In February 2008, we completed the sale of our ownership interest in cVidya Networks Inc. and received total proceeds of approximately $603,000 for the sale. We will record a capital gain of approximately $382,000 as a result of the transaction in 2008.



GENERAL

Our consolidated financial statements appearing in this annual report are prepared in U.S. dollars and in accordance with generally accepted accounting principles in the United States, or U.S. GAAP. Transactions and balances originally denominated in dollars are presented at their original amounts. Transactions and balances in other currencies are remeasured into dollars in accordance with the principles set forth in Financial Accounting Standards Board, or FASB, Statement No. 52. The majority of our sales are made outside Israel in dollars. In addition, substantial portions of our costs are incurred in dollars. Since the dollar is the primary currency of the economic environment in which we and certain of our subsidiaries operate, the dollar is our functional and reporting currency and, accordingly, monetary accounts maintained in currencies other than the dollar are remeasured using the foreign exchange rate at the balance sheet date. Operational accounts and non-monetary balance sheet accounts are measured and recorded at the exchange rate in effect at the date of the transaction. The financial statements of certain subsidiaries and an affiliate that we sold in November 2007 whose functional currency is not the dollar, have been translated into dollars. All balance sheet accounts have been translated using the exchange rates in effect at the balance sheet date. Statement of operations amounts have been translated using the average exchange rate for the period. The resulting translation adjustments are reported as a component of shareholders' equity in accumulated other comprehensive income (loss).

DISCUSSION OF CRITICAL ACCOUNTING POLICIES AND ESTIMATIONS

The preparation of financial statements in conformity with generally accepted accounting principles requires us to make estimates and assumptions that affect the reported amounts of assets and liabilities 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. Actual results could differ from those estimates and the use of different assumptions would likely result in materially different results of operations.

Critical accounting policies are those that are both most important to the portrayal of a company's financial position and results of operations, and require management's most difficult, subjective or complex judgments. Although not all of our significant accounting policies require management to make difficult, subjective or complex judgments or estimates, the following policies and estimates are those that we deem most critical:

REVENUE RECOGNITION. We account for our revenue in accordance with the provisions of Statement of Position, or SOP, No. 97-2, "SOFTWARE REVENUE RECOGNITION," issued by the American Institute of Certified Public Accountants and as amended by SOP No. 98-9 and related interpretations. 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:

- Persuasive evidence of an arrangement exists. We require evidence of an agreement with a customer specifying the terms and conditions of the products or services to be delivered typically in the form of a purchase order or the customer's signature on our proposal;
- Delivery has occurred. For software licenses, delivery takes place when the software is installed on site or remotely or is shipped via mail on a compact disc or server. For services, delivery takes place as the services are provided;
- The fee is fixed or determinable. Fees are fixed or determinable if they are not subject to a refund or cancellation and do not have payment terms that exceed our customary payment terms; and
- Collection is probable. We perform a credit review of all customers with significant transactions to determine whether a customer is credit worthy and collection is probable.



In general, revenue for transactions that do not involve software customization or services considered essential to the functionality of the software is recognized as follows: (i) software license fees for sales through OEMs are recognized upon receipt of license activity reports; (ii) all other software license fees are recognized upon delivery of the software; (iii) software maintenance and technical support are recognized ratably over the contract term; and (iv) consulting, training and other similar services are recognized as the services are performed.

We exercise judgment and use estimates in connection with the determination of the amount of product software license and services revenues to be recognized in each accounting period. If the fee due from the customer is not fixed or determinable, revenue is recognized as payments become due from the customer. If collection is not considered probable, revenue is recognized when the fee is collected. We record a provision to operating expenses for bad debts resulting from customers' inability to pay for the products or services they have received. These estimates are based on historical bad debt expense, analyses of credit memo data, and other known factors, such as bankruptcy. If the historical data we use to calculate these estimates do not accurately reflect future returns or bad debts, adjustments to these reserves may be required that would increase or decrease revenue or net income.

Many of our software arrangements involve multiple elements. Such elements typically include any or all of the following: software licenses, 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 allocate value to each undelivered element based on vendor specific objective evidence, or VSOE, of the fair value of each undelivered element in the arrangement, in accordance with the "residual method" prescribed by SOP No. 98-9, "MODIFICATION OF SOP NO. 97-2, SOFTWARE REVENUE RECOGNITION WITH RESPECT TO CERTAIN Transactions." The VSOE used by us to allocate the sales price to support services and maintenance is based on the renewal rate charged when these elements are sold separately. License revenues are recorded based on the residual method. Under the residual method, revenue is recognized for the delivered elements when (i) there is VSOE of the fair values of all the undelivered elements, and (ii) all revenue recognition criteria of SOP No. 97-2, as amended, as described above, are satisfied. Under the residual method any discount in the arrangement is allocated to the delivered element. If sufficient VSOE does not exist for all undelivered elements, revenue is deferred for the entire arrangement until all revenue recognition criteria are met for such undelivered elements.

Revenues from billing products which involve significant customization of our software to customer specific specifications are recognized in accordance with SOP No. 81-1, "ACCOUNTING FOR PERFORMANCE OF CONSTRUCTION-TYPE AND CERTAIN PRODUCTION-TYPE CONTRACTS," using contract accounting on a percentage of completion method, over the period from signing of the license through to customer acceptance in accordance with the "input method." The amount of revenue recognized is based on the total license fees under the license agreement and the percentage to completion achieved. The percentage to completion is measured by monitoring progress using records of actual costs incurred to date in the project compared with the total estimated project requirements. Estimates of total project requirements are based on prior experience of customization, delivery and acceptance of the same or similar technology and are reviewed and updated regularly by management.

Where arrangements recognized according to SOP No. 81-1 involve maintenance and support services, revenues are recognized according to Emerging Issues Task Force, or EITF, Issue No. 00-21, "REVENUES ARRANGEMENTS WITH MULTIPLY DELIVERIES," or EITF 00-21. According to EITF 00-21, a multiple-element arrangement (an arrangement that involves the delivery or performance of multiple products, services and/or rights to use assets) is separated into more than one unit of accounting, if the functionality of the delivered element is not dependent on the undelivered element, there is VSOE of fair value of the undelivered element and delivery of the delivered element represents the culmination of the earnings process for this element. We have established VSOE for maintenance and support services based on the renewal rate that will be charged when these elements are sold separately and therefore the arrangement consideration is allocated to maintenance and support services based on their relative VSOE.

After delivery, if uncertainty exists about customer acceptance of the software, license revenue is not recognized until acceptance. Provisions for estimated losses on uncompleted contracts are made in the period in which such losses are first determined, in the amount of the estimated loss on the entire contract. As of December 31, 2007, no such estimated losses were identified.



Estimated gross profit or loss from long-term contracts may change due to

changes in estimates resulting from differences between actual performance and original forecasts. Such changes in estimated gross profit are recorded in results of operations when they are reasonably determinable by management, on a cumulative catch-up basis.

We believe that the use of the percentage of completion method is appropriate as we have the ability to make reasonably dependable estimates of the extent of progress towards completion, contract revenues and contract costs. In addition, contracts executed include provisions that clearly specify the enforceable rights regarding services to be provided and received by the parties to the contracts, the consideration to be exchanged and the manner and terms of settlement. In all cases we expect to perform our contractual obligations and our licensees are expected to satisfy their obligations under the contract.

ALLOWANCES FOR DOUBTFUL ACCOUNTS. We perform ongoing credit evaluations of our customers' financial condition and we require collateral as deemed necessary. We maintain allowances for doubtful accounts for estimated losses resulting from the inability of our customers to make payments. In judging the adequacy of the allowance for doubtful accounts, we consider multiple factors including the aging of our receivables, historical bad debt experience and the general economic environment. Management applies considerable judgment in assessing the realization of receivables, including assessing the probability of collection and the current credit worthiness of each customer. If the financial condition of our customers were to deteriorate, resulting in an impairment of their ability to make payments, additional allowances may be required.

INCOME TAXES. Estimates and judgments are required in the calculation of certain tax liabilities and in the determination of the recoverability of certain of the deferred tax assets, which arise from net operating losses tax carryforwards and temporary differences between the tax and financial statement recognition of revenue and expense. Statement of Financial Accounting Standard, or SFAS, No. 109, "ACCOUNTING FOR INCOME TAXES," also requires that the deferred tax assets be reduced by a valuation allowance, if based on the weight of available evidence, it is more likely than not that some portion or all of the recorded deferred tax assets will not be realized in future periods.

In July 2006, the FASB issued Financial Interpretation No. 48, "ACCOUNTING FOR UNCERTAINTY IN INCOME TAXES - AN INTERPRETATION OF FASB STATEMENT NO. 109," or FIN 48. FIN 48 provides detailed guidance for the financial statement recognition, measurement and disclosure of uncertain tax positions recognized in an enterprise's financial statements in accordance with SFAS No. 109. Income tax positions must meet a more-likely-than-not recognition threshold at the effective date to be recognized upon the adoption of FIN 48 and in subsequent periods. We adopted FIN 48 effective January 1, 2007 and the provisions of FIN 48 have been applied to all income tax positions commencing from that date. As of January 1, 2007 there was no difference between the provisions of SFAS 109 and FIN 48 therefore no adjustment was recorded to the retained earnings.

Prior to 2007 the Company determined its tax contingencies in accordance with SFAS 5, Accounting for Contingencies, or SFAS 5. The Company recorded estimated tax liabilities to the extent the contingencies were probable and could be reasonably estimated.

In evaluating our ability to recover our deferred tax assets, in full or in part, we consider all available positive and negative evidence including our past operating results, the existence of cumulative losses in the most recent fiscal years and our forecast of future taxable income on a jurisdiction by jurisdiction basis. In determining future taxable income, we are responsible for assumptions utilized, including the amount of Israeli and international pre-tax operating income, the reversal of temporary differences and the implementation of feasible and prudent tax planning strategies. These assumptions require significant judgment about the forecasts of future taxable income and are

consistent with the plans and estimates we use to manage the underlying businesses.



Based on estimates of future taxable profits and losses in certain foreign tax jurisdictions, we determined that a valuation allowance of $4.3 million was required for tax loss carryforwards and other temporary differences as of December 31, 2007. If these estimates prove inaccurate, a change in the valuation allowance could be required in the future.

CONTINGENCIES. We are involved in legal proceedings and other claims from time to time. 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, if any, for any contingencies are made after careful analysis of each individual claim. The required reserves may change due to future developments in each matter or changes in approach, such as a change in the settlement strategy in dealing with any contingencies, which may result in higher net loss. If actual results are not consistent with our assumptions and judgments, we may be exposed to gains or losses that could be material. See "Item 8A. Financial Information - Consolidated Statements and Other Financial Information - Legal Proceedings."

GOODWILL AND OTHER INTANGIBLE ASSETS AND LONG-LIVED ASSETS. As of December 31, 2006, we had recorded goodwill of approximately $1.9 million attributable to the acquisition of the billing activity of Teleknowledge in December 2004. As of December 31, 2006 and 2007, we had recorded goodwill of approximately $166,000 and $772,000, respectively, attributable to the acquisition of the TEM activity of Telsoft on July 31,2006. On January 1, 2002, we adopted SFAS No. 142, "GOODWILL AND OTHER INTANGIBLE ASSETS," or SFAS No. 142. SFAS No. 142 requires goodwill to be tested for impairment on adoption of the statement, at least annually thereafter, and between annual tests if certain circumstances or indicators of impairment occur, and written down when impaired, rather than being amortized as previous accounting standards required. Goodwill is tested for impairment by comparing the fair value of our reportable units with their carrying value. Fair value is determined using discounted cash flows. Significant estimates used in the methodologies include estimates of future cash flows, future short-term and long-term growth rates, weighted average cost of capital and estimates of market multiples for the reportable units. We have elected to perform our analysis of goodwill at the end of the third quarter of the year. During the first six months of 2007, due to indicators of impairment that occurred, we reviewed our goodwill and determined that there was an indication that the goodwill relating to the acquisition of the Teleknowledge billing activity had been impaired due to the significant decrease in revenues from the activity and delay in receipt of new purchase orders. We assessed the recoverable amount of such goodwill, based on our projections and using expected future discounted cash flows. Based on such review, as of June 30, 2007, we determined that the goodwill in the amount of $1.9 million relating to the acquisition of the Teleknowledge billing activity had been impaired and the carrying value was written off.

Our long-lived assets and certain identifiable intangibles are reviewed for impairment in accordance with SFAS No. 144, "ACCOUNTING FOR THE IMPAIRMENT OR DISPOSAL OF LONG-LIVED ASSETS," whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. Recoverability of the carrying amount 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 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. During the first six months of 2007, we reviewed our goodwill and determined that there was an indication that the goodwill relating to the acquisition of the Teleknowledge billing activity had been impaired due to the significant decrease in revenues from the activity and delay in receipt of new purchase orders. Based on such review, as of June 30, 2007, we determined that intangible assets relating to the Teleknowledge acquisition has been impaired, and as a result, we recorded an impairment loss in the amount of $434,000.



RESULTS OF OPERATIONS

The following table presents certain financial data expressed as a percentage of total revenues for the periods indicated:

| | Year Ended December 31, | | |
|---|---|---|---|
| | 2005 | 2006 | 2007 |
| Revenues: | | | |
| Product sales | 66.0% | 71.7% | 61.7% |
| Services | 34.0 | 28.3 | 38.3 |
| Total revenues | 100.0% | 100.0% | 100.0% |
| Cost of revenues: | | | |
| Product sales | 25.7 | 25.1 | 20.0 |
| Services | 7.2 | 6.9 | 9.3 |
| Total cost of revenues | 32.9 | 32.0 | 29.3 |
| Gross profit | 67.1 | 68.0 | 70.7 |
| Selling and marketing | 41.5 | 29.4 | 37.3 |
| Research and development, net | 38.0 | 34.7 | 28.3 |
| General and administrative | 24.5 | 25.3 | 39.6 |
| Impairment of goodwill and other intangible assets | -- | -- | 24.8 |
| Operating loss | (36.9) | (21.4) | (59.3) |
| Financial expenses (income), net | 0.5 | (0.5) | (1.1) |
| Capital loss on sale of long-term investment | -- | -- | (0.7) |
| Loss before taxes on income | (36.4) | (21.9) | (61.1) |
| Taxes on income (benefit), net | 0.1 | 1.1 | (0.7) |
| Net loss before equity in earnings (losses) of affiliate | (36.5) | (23.0) | (60.4) |
| Equity in earnings (losses) of affiliate | 0.0 | 1.5 | (2.1) |
| Net loss | (36.5) | (21.5) | (62.5) |

YEARS ENDED DECEMBER 31, 2007 AND 2006

REVENUES FROM PRODUCTS AND SERVICES. Revenues from products and services consist primarily of software license fees sales, hardware sales and revenues from services, including service bureau, maintenance, training, professional services and support. Revenues from products and services decreased by 10.9% to

$9.3 million for the year ended December 31, 2007 from $10.5 million for the year ended December 31, 2006. Revenues from products and services from our wholly-owned U.S. subsidiary, MTS IntegraTRAK, decreased by 8.1% to $4.9 million, or 52.7% of our total revenues, for the year ended December 31, 2007 from $5.4 million, or 51.1% of our total revenues, for the year ended December 31, 2006. The decrease in revenues from products and services in 2007 is primarily attributable to a longer sales cycle for our solutions during the year ended December 31, 2007 compared with the year ended December 31, 2006. We anticipate that our revenues from products and services will remain constant in 2008.

COST OF REVENUES FROM PRODUCTS AND SERVICES. Cost of revenues from products and services consists primarily of (i) production costs (including hardware, media, packaging, freight and documentation); (ii) certain royalties and licenses payable to third parties (including the Office of the Chief Scientist of the Ministry of Industry, Trade and Labor of the State of Israel), (iii) professional services costs; and (iv) warranty and support costs for up to one year for end-users and up to 15 months for our OEM distributors. Cost of revenues from products and services decreased by 18.5% to $2.7 million for the year ended December 31, 2007 from $3.4 million for the year ended December 31, 2006. The decrease in cost of revenues from products and services is primarily a result of a reduction in the number of employees in training and technical support.



SELLING AND MARKETING. Selling and marketing expenses consist primarily of costs relating to sales representatives and their travel expenses, trade shows and marketing exhibitions, advertising and presales support. Selling and marketing expenses increased by 13.1% to $3.5 million for the year ended December 31, 2007 from $3.1 million for the year ended December 31, 2006. The increase in selling and marketing expenses is primarily attributable to the integration of the activity of TelSoft and additional state sales taxes that we recorded as a result of a state sales tax assessment of our U.S. subsidiary, which increase was off-set in part by a reduction in the number of sales and marketing employees worldwide and related expenditures during 2007.

RESEARCH AND DEVELOPMENT, NET. Research and development, net expenses consist primarily of salaries of employees engaged in on-going research and development activities, outsourcing subcontractor development and other related costs, net of grants that were approved by the Office of the Chief Scientist of the Ministry of Industry, Trade and Labor of the State of Israel. Research and development, net expenses decreased by 27.3% to $2.6 million for the year ended December 31, 2007 (net of the grant from the Office of the Chief Scientist in the amount of $469,000) from $3.6 million for the year ended December 31, 2006 (net of the grant from the Office of the Chief Scientist in the amount of $578,000). The decrease in research and development, net expenses is primarily attributable to the reduction in the number of employees engaged in research and development and their related expenditure and reduction in costs related to research and development subcontractors.

GENERAL AND ADMINISTRATIVE. General and administrative expenses consist primarily of compensation costs for administration, finance and general management personnel, professional fees and office maintenance and administrative costs. General and administrative expenses increased by 39.4% to $3.7 million for the year ended December 31, 2007 from $2.7 million for the year ended December 31, 2006. The increase in general and administrative expenses is primarily attributable to the integration of the activity of TelSoft, a write-off of obsolete and slow moving inventory, a write-off of tax advances

paid to the Israeli Tax Authority that we do not expect to able to utilize, a contingent liability provision we recorded due to a claim of a former Brazilian employee and an increase in the allowance for doubtful accounts.

IMPAIRMENT OF GOODWILL AND OTHER INTANGIBLE ASSETS. Impairment of goodwill and other intangible assets was approximately $2.3 million for the year ended December 31, 2007 as a result of our determination that the goodwill and intangible assets relating to the acquisition of the Teleknowledge billing activity had been impaired and to write off their carrying value. We did not record any impairment of goodwill and other intangible assets for the year ended December 31, 2006.

FINANCIAL EXPENSES (INCOME), NET. Financial expenses (income), net consists primarily of gains on marketable securities, interest income on bank deposits, bank commissions, bank interest and foreign currency translation adjustments. Financial expenses for the year ended December 31, 2007 were $105,000, compared to financial expenses of $54,000 for the year ended December 31, 2006. The increase in our financial expenses for the year ended December 31, 2007 is primarily attributable to the decrease in our holdings of cash and cash equivalents and an increase in interest paid on a bank loan.

CAPITAL LOSS ON SALE OF LONG-TERM INVESTMENT. We recorded a capital loss on sale of long-term investment of $63,000 for the year ended December 31, 2007 as a result of the sale of our 1% ownership interest in Online Media Solutions Ltd. for total proceeds of approximately $36,000. The transaction was consummated in December 2007. We did not record a capital loss on sale of long-term investment for the year ended December 31, 2006.

TAXES ON INCOME (BENEFIT), NET. We recorded a tax benefit of $68,000 for the year ended December 31, 2007, compared to a tax on income of $118,000 for the year ended December 31, 2006. The tax benefit for the year ended December 31, 2007 is attributable to the recognition of a deferred tax asset related to carry forward tax losses of our subsidiary in Hong Kong and a decrease in a deferred tax liability in the United States. The tax on income for the year ended December 31, 2006 is primarily attributable to a tax reserve that we established in 2006 for possible tax liabilities relating to prior years.



EQUITY IN EARNINGS (LOSSES) OF AFFILIATE. Prior to the sale of our 50% ownership interest in Jusan S.A., our Spanish affiliate, in November 2007, we recognized income and loss from the operations of Jusan S.A. For the year ended December 31, 2006, we recognized income of $159,000 from the operations of Jusan S.A. As a result of the sale of Jusan S.A. in November 2007, we recorded a loss of $197,000 from the operations of Jusan S.A for the year ended December 31,2007.

YEARS ENDED DECEMBER 31, 2006 AND 2005

REVENUES FROM PRODUCTS AND SERVICES. Revenues decreased by 9.3% to $10.5 million for the year ended December 31, 2006 from $11.6 million for the year ended December 31, 2005. Revenues from our wholly-owned U.S. subsidiary, MTS IntegraTRAK, decreased by 11.4% to $5.4 million, or 51.1% of our total revenues, for the year ended December 31, 2006 from $6.0 million, or 52.3% of our total revenues, for the year ended December 31, 2005. The decrease in revenues in 2006 is primarily attributable to a longer sales cycle for our solutions during the year ended December 31, 2006 compared with the year ended December 31, 2005.

COST OF REVENUES FROM PRODUCTS AND SERVICES. Cost of revenues decreased by

11.8% to $3.3 million for the year ended December 31, 2006 from $3.8 million for the year ended December 31, 2005. The decrease in cost of revenues is consistent with the decrease in revenues and principally a result of a reduction in the number of employees in professional services and technical support departments.

SELLING AND MARKETING. Selling and marketing expenses decreased by 35.8% to $3.1 million for the year ended December 31, 2006 from $4.8 million for the year ended December 31, 2005. The decrease in selling and marketing expenses is primarily attributable to our reliance on establishing and maintaining partnerships with leading OEMs and vendors for various initiatives and a reduction in the number of our selling and marketing personnel.

RESEARCH AND DEVELOPMENT, NET. Research and development, net expenses decreased by 17.3% to $3.6 million for the year ended December 31, 2006 (net of the grant from the Office of the Chief Scientist in the amount of $578,000) from $4.4 million for the year ended December 31, 2005 (net of the grant from the Office of the Chief Scientist in the amount of $130,000). The decrease in research and development, net expenses is primarily attributable to the reduction in the number of employees engaged in research and development and the increase in the participation of the Office of the Chief Scientist in 2006.

GENERAL AND ADMINISTRATIVE. General and administrative expenses decreased by 6.3% to $2.7 million for the year ended December 31, 2006 from $2.8 million for the year ended December 31, 2005. The decrease in general and administrative expenses is primarily attributable to the decrease in expenses associated with the integration of the activity of Teleknowledge Group Ltd., or Teleknowledge, that were incurred in the year ended December 31, 2005.

IMPAIRMENT OF GOODWILL AND OTHER INTANGIBLE ASSETS. We did not record any impairment of goodwill and other intangible assets for the years ended December 31, 2006 and December 31, 2005.

FINANCIAL EXPENSES (INCOME), NET. Financial expenses for the year ended December 31,2006 were $54,000 compared to financial income of $53,000 for the year ended December 31,2005. The decrease in our financial income for the year ended December 31, 2006 is primarily attributable to the decrease in our holdings of cash and cash equivalents, interest paid on a bank loan and decrease in gains on marketable securities.

CAPITAL LOSS ON SALE OF LONG-TERM INVESTMENT. We did not record a capital loss on sale of long-term investment for the years ended December 31, 2006 and December 31, 2005.

TAXES ON INCOME (BENEFIT), NET. We recorded tax on income of $118,000 for the year ended December 31, 2006, compared to tax on income of $10,000 for the year ended December 31, 2005. The increase in tax on income is primarily attributable to a tax reserve that we established in 2006 for possible tax liabilities relating to prior years.



EQUITY IN EARNINGS (LOSSES) OF AFFILIATE. Prior to the sale of our 50% ownership interest in Jusan S.A., our Spanish affiliate, in November 2007, we recognized income and loss from the operations of Jusan S.A. For the years ended December 31, 2006 and 2005, we recognized income of $159,000 and $2,000, respectively, from the operations of Jusan S.A.

QUARTERLY RESULTS OF OPERATIONS

The following tables set forth certain unaudited quarterly financial information for each of the eight fiscal quarters ended December 31, 2007, in dollars and as a percentage of revenues. In management's opinion, this data has been prepared on a basis consistent with our audited consolidated financial statements included elsewhere in this annual report and include all necessary adjustments, consisting only of normal recurring adjustments, that we consider necessary for a fair presentation of the unaudited information for the quarters presented. The operating results for any quarter are not necessarily indicative of results that we might achieve for any future periods.

| | For the Three Month Periods Ended | | | |
|---|---|---|---|---|
| | Mar. 31, 2006 | Jun. 30, 2006 | Sept. 30, 2006 | Dec. 31, 2006 |
| Revenues | $ 2,814 | $ 2,704 | $ 2,652 | $ 2, |
| Cost of revenues | 934 | 894 | 813 | |
| Gross profit | 1,880 | 1,810 | 1,839 | 1, |
| Selling and marketing | 830 | 753 | 814 | |
| Research and development, net | 1,060 | 898 | 915 | |
| General and administrative | 578 | 630 | 746 | |
| Impairment of goodwill and other intangibles assets | -- | -- | -- | |
| Operating expenses | 2,468 | 2,281 | 2,475 | 2, |
| Operating loss | (588) | (471) | (636) | ( |
| Financial (expenses) income, net | 37 | (26) | (60) | |
| Capital loss on sale of long-term investment | -- | -- | -- | |
| Loss before taxes on income | (551) | (497) | (696) | ( |
| Tax on income (benefit), net | 3 | -- | -- | |
| Net loss before equity in earnings (losses) of affiliate | (554) | (497) | (696) | ( |
| Equity in earnings (losses) of affiliate | 69 | 49 | 52 | |
| Net loss | $ (485) | $ (448) | $ (644) | $ ( |
| Basic and diluted net loss per share | $ (0.08) | $ (0.08) | $ (0.11) | $ (0 |
| Weighted average number of ordinary shares used in computing basic net loss per share | 5,744,864 | 5,763,845 | 5,765,289 | 5,773, |
| Weighted average number of ordinary shares used in computing diluted net loss per share | 5,744,864 | 5,763,845 | 5,765,289 | 5,773, |
| Revenues | 100.0% | 100.0% | 100.0% | 10 |
| Cost of revenues | 33.2 | 33.1 | 30.7 | 3 |
| Gross profit | 66.8 | 66.9 | 69.3 | 6 |
| Selling and marketing | 29.5 | 27.8 | 30.7 | 2 |

| | | | | |
|---|---|---|---|---|
| Research and development, net | 37.7 | 33.2 | 34.5 | 3 |
| General and administrative | 20.5 | 23.3 | 28.1 | 3 |
| Impairment of goodwill and other intangible assets | - | - | - | |
| Operating expenses | 87.7 | 84.3 | 93.3 | 9 |
| Operating loss | (20.9) | (17.4) | (24.0) | (2 |
| Financial (expenses) income, net | 1.3 | (1.0) | (2.3) | ( |
| Capital loss on sale of long-term investment | - | - | - | |
| Loss before taxes on income | (19.6) | (18.4) | (26.3) | (2 |
| Taxes on income (benefit), net | 0.1 | - | - | |
| Net loss before equity in earnings (losses) of affiliate. | (19.7) | (18.4) | (26.3) | (2 |
| Equity in earnings (losses) of affiliate | 2.5 | 1.8 | 2.0 | ( |
| Net loss | (17.2)% | (16.6)% | (24.3)% | (2 |

| | For the Three Month Periods Ended | | | |
|---|---|---|---|---|
| | Mar. 31, 2007 | Jun. 30, 2007 | Sept. 30, 2007 | Dec. 3 2007 |
| Revenues | $ 2,446 | $ 2,505 | $ 2,187 | $ 2, |
| Cost of revenues | 628 | 753 | 790 | |
| Gross profit | 1,818 | 1,752 | 1,397 | 1, |
| Selling and marketing | 836 | 803 | 1,011 | |
| Research and development, net | 886 | 562 | 645 | |
| General and administrative | 698 | 821 | 1,193 | |
| Impairment of goodwill and other intangibles assets | -- | 2,312 | -- | |
| Operating expenses | 2,420 | 4,498 | 2,849 | 2, |
| Operating loss | (602) | (2,746) | (1,452) | ( |
| Financial (expenses) income, net | (15) | 2 | (18) | |
| Capital loss on sale of long-term investment | -- | -- | --* | |
| Loss before taxes on income | (617) | (2,744) | (1,470) | ( |
| Tax on income (benefit), net | -- | -- | -- | |
| Net loss before equity in earnings (losses) of affiliate | (617) | (2,744) | (1,470) | ( |
| Equity in earnings (losses) of affiliate | 32 | (58) | (206)* | |
| Net loss | $ (585) | $ (2,802) | $ (1,676) | $ ( |
| Basic and diluted net loss per share | $ (0.10) | $ (0.49) | $ (0.29) | $ (0 |
| Weighted average number of | | | | |

| | | | | |
|---|---|---|---|---|
| ordinary shares used in computing basic net loss per share | 5,773,845 | 5,773,845 | 5,773,845 | 5,773, |
| Weighted average number of ordinary shares used in computing diluted net loss per share | 5,773,845 | 5,773,845 | 5,773,845 | 5,773, |
| Revenues | 100.0% | 100.0% | 100.0% | 10 |
| Cost of revenues | 25.7 | 30.1 | 36.1 | 2 |
| Gross profit | 74.3 | 69.9 | 63.9 | 7 |
| Selling and marketing | 34.2 | 32.1 | 46.2 | 3 |
| Research and development, net | 36.2 | 22.4 | 43.2 | 2 |
| General and administrative | 28.5 | 32.8 | 54.5 | 4 |
| Impairment of goodwill and other intangible assets | - | 92.3 | - | |
| Operating expenses | 98.9 | 179.6 | 130.3 | 10 |
| Operating loss | (24.6) | (109.6) | (66.4) | (3 |
| Financial (expenses) income, net | (0.6) | 0.1 | (0.8) | ( |
| Capital loss on sale of long-term investment | - | - | -* | ( |
| Loss before taxes on income | (25.2) | (109.5) | (67.2) | (2 |
| Taxes on income (benefit), net | - | - | - | ( |
| Net loss before equity in earnings (losses) of affiliate. | (25.2) | (109.5) | (67.2) | (3 |
| Equity in earnings (losses) of affiliate | 1.3 | (2.3) | (9.4)* | |
| Net loss | (23.9) | (111.8) | (76.6) | (3 |

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* Reclassified



SEASONALITY

Our operating results are generally not characterized by a seasonal pattern except that our volume of sales in Europe is generally lower in the summer months.

Impact of Currency Fluctuation and of Inflation

We report our financial results in dollars and receive payments in dollars for most of our sales, while a significant amount of our expenses, primarily salaries, are paid in NIS. Therefore, the dollar cost of our operations in Israel is influenced by the extent to which any increase in the rate of inflation in Israel is not offset, or is offset on a lagging basis, by a devaluation of the NIS in relation to the dollar. When the rate of inflation in Israel exceeds the rate of devaluation of the NIS against the dollar, the dollar cost of our operations in Israel increase. If the dollar cost of our operations in Israel increases, our dollar-measured results of operations will be adversely

affected. We cannot assure you that we will not be materially and adversely affected in the future if inflation in Israel exceeds the devaluation of the NIS against the dollar or if the timing of the devaluation lags behind inflation in Israel.

The following table presents information about the rate of inflation in Israel, the rate of devaluation or appreciation of the NIS against the dollar, and the rate of inflation in Israel adjusted for the devaluation:

| Year ended December 31, | Israeli inflation rate % | NIS devaluation (appreciation) rate % | Israeli inflation adjusted for devaluation (appreciation) % |
|---|---|---|---|
| 2003 | (1.9) | (7.6) | 5.7 |
| 2004 | 1.2 | (1.6) | 2.8 |
| 2005 | 2.4 | 6.8 | (4.4) |
| 2006 | (0.1) | (8.2) | 8.1 |
| 2007 | 3.4 | (9.0) | 12.4 |

A devaluation of the NIS in relation to the dollar has the effect of reducing the dollar amount of any of our expenses or liabilities which are payable in NIS, unless those expenses or payables are linked to the dollar. This devaluation also has the effect of decreasing the dollar value of any asset which consists of NIS or receivables payable in NIS, unless the receivables are linked to the dollar. Conversely, any increase in the value of the NIS in relation to the dollar has the effect of increasing the dollar value of any unlinked NIS assets and the dollar amounts of any unlinked NIS liabilities and expenses. During 2007, the NIS appreciated against the U.S. dollar, which resulted in a significant increase in the U.S. dollar cost of our NIS expenses. Such trend continued during the first three months of 2008 with further devaluation of the U.S. dollar compared to the NIS.



Because exchange rates between the NIS and the dollar fluctuate continuously, exchange rate fluctuations, particularly larger periodic devaluations, may have an impact on our profitability and period-to-period comparisons of our results. We cannot assure you that in the future our results of operations may not be materially adversely affected by currency fluctuations.

CONDITIONS IN ISRAEL

We are incorporated under the laws of, and our principal executive offices and manufacturing and research and development facilities are located in, the State of Israel. See Item 3D "Key Information - Risk Factors - Risks Relating to Our Location in Israel" for a description of governmental, economic, fiscal, monetary or political polices or factors that have materially affected or could materially affect our operations.

TRADE RELATIONS

Israel is a member of the United Nations, the International Monetary Fund, the International Bank for Reconstruction and Development and the International Finance Corporation. Israel is a member of the World Trade Organization and is a signatory to the General Agreement on Tariffs and Trade, which provides for reciprocal lowering of trade barriers among its members. In addition, Israel has been granted preferences under the Generalized System of Preferences from the

United States, Australia, Canada and Japan. These preferences allow Israel to export products covered by such programs either duty-free or at reduced tariffs.

Israel and the European Union Community concluded a Free Trade Agreement in July 1975, which confers certain advantages with respect to Israeli exports to most European countries and obligates Israel to lower its tariffs with respect to imports from these countries over a number of years. In 1985, Israel and the United States entered into an agreement to establish a Free Trade Area. The Free Trade Area has eliminated all tariff and specified non-tariff barriers on most trade between the two countries. On January 1, 1993, an agreement between Israel and the European Free Trade Association, known as EFTA, established a free-trade zone between Israel and the EFTA nations. In November 1995, Israel entered into a new agreement with the European Union, which includes redefinement of rules of origin and other improvements, including providing for Israel to become a member of the research and technology programs of the European Union. In recent years, Israel has established commercial and trade relations with a number of other nations, including China, India, Russia, Turkey and other nations in Eastern Europe and Asia.

EFFECTIVE CORPORATE TAX RATE

Israeli companies are generally subject to income tax on their taxable income. The applicable rate for 2007 was 29%, which was reduced to 27% in 2008 and will be further reduced to 26% in 2009 and 25% in 2010 and thereafter.

However, certain of our manufacturing facilities have been granted "Approved Enterprise" status under the Law for the Encouragement of Capital Investments, 1959, as amended, commonly referred to as the Investment Law, and, consequently, are eligible, subject to compliance with specified requirements, for tax benefits beginning when such facilities first generate taxable income. Subject to certain restrictions, we are entitled to a tax exemption in respect of income derived from our approved facilities for a period of two years, commencing in the first year in which such income is earned, and will be entitled to a reduced tax rate of 10%-25% for an additional five to eight years if we qualify as a foreign investors' company. If we do not qualify as a foreign investors' company, we will instead be entitled to a reduced rate of 25% for an additional five, rather than eight, years.



Our taxes outside Israel are dependent on our operations in each jurisdiction as well as relevant laws and treaties. Under Israeli tax law, the results of our foreign consolidated subsidiaries, which have generally been unprofitable, cannot be consolidated for tax purposes with the results of operations of the parent company.

RECENTLY ISSUED ACCOUNTING STANDARDS

In September 2006, the FASB issued SFAS No. 157, "FAIR VALUE MEASUREMENTS," or SFAS No. 157. SFAS No. 157 provides a single definition of fair value, a framework for measuring fair value, and expanded disclosures concerning fair value. Previously, different definitions of fair value were contained in various accounting pronouncements creating inconsistencies in measurement and disclosures. SFAS No. 157 applies under those previously issued pronouncements that prescribe fair value as the relevant measure of value, except SFAS No. 123(R) and related interpretations. SFAS No. 157 does not apply to accounting standards that require or permit measurement similar to fair value but are not intended to measure fair value. SFAS No. 157 is effective for fiscal years beginning after November 15, 2007. We are currently evaluating the impact of

adopting SFAS No. 157.

In February 2007, the FASB issued SFAS No. 159, "THE FAIR VALUE OPTION FOR FINANCIAL ASSETS AND FINANCIAL LIABILITIES," or SFAS No. 159. SFAS No. 159 provides companies with an option to report selected financial assets and liabilities at fair value. Generally accepted accounting principles have required different measurement attributes for different assets and liabilities that can create artificial volatility in earnings. The Standard's objective is to reduce both complexity in accounting for financial instruments and the volatility in earnings caused by measuring related assets and liabilities differently. SFAS No. 159 is effective as of the beginning of an entity's first fiscal year beginning after November 15, 2007. We are currently evaluating the impact of the adoption of SFAS No. 159.

In June 2007, the FASB ratified Emerging Issues Task Force, or EITF, Issue No. 07-3, "ACCOUNTING FOR NON REFUNDABLE ADVANCE PAYMENTS FOR GOODS OR SERVICES RECEIVED FOR USE IN FUTURE RESEARCH AND DEVELOPMENT ACTIVITIES," or EITF 07-3. EITF 07-3 requires that nonrefundable advance payments for goods or services that will be used or rendered for future research and development activities be deferred and capitalized and recognized as an expense as the goods are delivered or the related services are performed. EITF 07-3 is effective, on a prospective basis, for fiscal years beginning after December 15, 2007 and will be adopted in the first quarter of fiscal year 2008. We are currently evaluating the impact of the pending adoption of EITF 07-3 on our consolidated financial statements.

In December 2007, the FASB issued SFAS No. 141(R), "BUSINESS COMBINATIONS," or SFAS 141(R). SFAS 141(R) establishes principles and requirements for how the acquirer of a business recognizes and measures in its financial statements the identifiable assets acquired, the liabilities assumed, and any noncontrolling interest in the acquiree. The statement also provides guidance for recognizing and measuring the goodwill acquired in the business combination and determines what information to disclose to enable users of the financial statement to evaluate the nature and financial effects of the business combination. SFAS 141(R) is effective for financial statements issued for fiscal years beginning after December 15, 2008. Accordingly, any business combinations we engage in will be recorded and disclosed following existing GAAP until January 1, 2009. We are currently evaluating the impact of the adoption of SFAS 141(R) on our future consolidated financial statements.

In December 2007, the FASB issued SFAS No. 160, "NONCONTROLLING INTEREST IN CONSOLIDATED FINANCIAL STATEMENTS," or SFAS 160. SFAS 160 re-characterizes minority interests in consolidated subsidiaries as non-controlling interests and requires the classification of minority interests as a component of equity. Under SFAS 160, a change in control will be measured at fair value, with any gain or loss recognized in earnings. The effective date for SFAS 160 is for annual periods beginning on or after December 15, 2008. Early adoption and retroactive application of SFAS 160 to fiscal years preceding the effective date are not permitted. We are currently evaluating the impact of the adoption of SFAS 160 on our future consolidated financial statements.



B. LIQUIDITY AND CAPITAL RESOURCES

On December 31, 2007, we had $1.4 million in cash and cash equivalents, $169,000 in marketable securities and a working capital deficit of $2.0 million, compared to $1.5 million in cash and cash equivalents, $100,000 in short-term bank deposits, $159,000 in marketable securities and working capital of $186,000 on December 31, 2006. The decrease in working capital at December 31, 2007 was

primarily attributable to the decrease in trade receivables and to the increase in accrued expenses and other liabilities.

On August 10, 2005, we raised $2.8 million (before issuance costs) in a private placement of 937,500 ordinary shares to institutional and private investors. The private placement also involved the acquisition by the investors of warrants to purchase an aggregate of 375,000 ordinary shares at an exercise price of $4.00 per share (subject to anti-dilution adjustments), exercisable from February 10, 2006 until August 10, 2009.

To improve our cash position and working capital, in November 2007, we sold our 50% ownership interest in Jusan S.A. in consideration of 700,000 Euros (approximately $1.0 million) plus the payment of 25% of the net income of Jusan S.A. during the period commencing upon completion of the sale and ending June 30, 2008. We recorded an equity loss of $197,000 as a result of the transaction.

On February 4, 2008, we completed the sale of our ownership interest in cVidya Networks Inc. and received total proceeds of approximately $603,000 for the sale. We will record a capital gain of approximately $382,000 as a result of the transaction in the first quarter of 2008.

On February 11, 2008, we raised $750,000 in a private issuance of 750,000 ordinary shares to an investor.

One of the principal factors affecting our working capital is the payment cycle on our sales. Any material change in the current aging of our accounts receivable could have an adverse effect on our working capital.

We currently do not have significant capital spending or purchase commitments, but we expect to continue to engage in capital spending consistent with the level of our operations. We anticipate that our cash on hand and cash flow from operations will be sufficient to meet our working capital and capital expenditure requirements for at least 12 months. However, if we do not generate sufficient cash from operations, we may be required to obtain additional financing or to reduce level of expenditure. There can be no assurance that such financing will be available in the future, or, if available, will be on terms satisfactory to us.

We are not in compliance with certain financial covenants and may not be able to obtain or maintain compliance with those financial covenants in the future

CASH FLOWS

The following table summarizes our cash flows for the periods presented:

| | Year ended December 31, | |
|---|---|---|
| | 2006 | 2007 |
| | ($ in thousands) | |
| Net cash used in operating activities | (1,609) | (615) |
| Net cash provided by (used in) investing activities | (1,206) | 976 |
| Net cash provided by (used in) financing activities | 1,098 | (398) |
| Net decrease in cash and cash equivalents | (1,717) | (37) |
| Cash and cash equivalents at beginning of period | 3,191 | 1,474 |
| Cash and cash equivalents at end of period | 1,474 | 1,437 |

Net cash used in operating activities was approximately $615,000 for the year ended December 31, 2007. The use of our funds in 2007 was primarily attributable to our continuing investment in product development. Net cash used in operating activities was approximately $1.6 million for the year ended December 31, 2006. The use of our funds in 2006 was primarily attributable to our continuing investment in product development. The decrease in the use of our funds in the 2007 period is primarily attributable to our cash management efforts and our on-going monitoring and reduction of expenses in order to achieve sustainable growth.

Net cash provided by investing activities was approximately $976,000 for the year ended December 31, 2007, primarily attributable to the proceeds from the sale of Jusan S.A. Net cash used in investing activities was approximately $1.2 million for the year ended December 31, 2006, primarily attributable to the acquisition of certain assets and liabilities of TelSoft in July 2006.

Net cash used in financing activities was approximately $398,000 for the year ended December 31, 2007, compared to approximately $1.1 million provided by financing activities for the year ended December 21, 2006. Of the cash used in financing activities in 2007, approximately $417,000 was attributable to the repayment of a long-term loan received from Bank Hapoalim to finance the acquisition of Telsoft. Of the cash provided by financing activities in 2006, approximately $1.0 million was attributable to the loan we obtained from Bank Hapoalim and $100,000 was attributable to proceeds from exercise of stock options.

On July 27, 2006, we obtained a $1.0 million loan from Bank Hapoalim in order to facilitate the funding of the TelSoft acquisition. The loan principal is payable in 12 equal monthly installments commencing August 31, 2007 and bears annual interest at the monthly London Inter Bank Offered Rate (LIBOR) plus 2%, payable on a monthly basis commencing August 31, 2006. Under the terms of the loan, we are required to maintain (i) shareholders' equity of not less than $5 million and 40% of our total assets; (ii) operating profit over two consecutive quarters as of the second quarter of 2007; and (iii) cash and cash equivalents of not less than $1 million. As a security interest for the repayment of the loan, we agreed to grant Bank Hapoalim a floating-charge over all of our company's assets, a fixed charge over our company's share capital, goodwill and rights to an exemption from taxation or reduced tax, and a fixed charge over all of the securities, documents and notes in the possession of Bank Hapoalim. We are not in compliance with such covenants. As of December 31, 2007, we had repaid five monthly installments including interest in an aggregate amount of $417,000.

We currently do not have significant capital spending or purchase commitments, but we expect to engage in capital spending consistent with the level of our operations. We anticipate that our cash on hand and cash flow from operations will be sufficient to meet our working capital and capital expenditure requirements for at least 12 months. However, if we do not generate sufficient cash from operations, we may be required to obtain additional financing or to reduce level of expenditure. There can be no assurance that such financing will be available in the future, or, if available, will be on terms satisfactory to us.

C. RESEARCH AND DEVELOPMENT

Our product development plans are market-driven and address the major, fast-moving trends that are influencing the telecommunications industry. We intend to expand upon our existing family of TEM solutions by adding new features and functions to address evolving market needs. We work closely with our customers and prospective customers to determine their requirements and

design enhancements and new releases to meet their needs. Research and development activities take place in our facilities in Israel. We employed 29 persons in research and development as of December 31, 2007, as compared to 37 persons in research and development as of December 31, 2006.

Our quality management system has been ISO 9001:2000 certified since the beginning of 2006, and prior thereto was ISO 9001:1994 certified.

We are evaluating approaches to solutions which will permit an information technology manager to effectively measure the quality of the services received from their service providers and to ensure that the users within the organization received such services according to their needs and the overall policy and priorities of the organization.



We have committed substantial financial resources to research and development for our TEM and billing solution activities. During 2005, 2006 and 2007, our net research and development expenditures were $4.4 million, $3.6 million and $2.6 million, respectively. In the past, we received funding from the Israeli Ministry of Industry, Trade and Labor's Office of the Chief Scientist for selected research and development projects, but we stopped seeking funding for a number of years. In late 2005 and early 2006 and 2007, we applied to the Office of the Chief Scientist for new grants for our research and development projects and we have subsequently received approval for such applications.

Under the terms of research and development grants that we have received from the Office of the Chief Scientist, we are required to pay royalties on the revenues derived from products incorporating know-how developed with such grants and ancillary services in connection therewith, up to 100% to 150% of the dollar-linked value of the total grants, plus interest. We are required to pay royalties at a rate of 3%-5%. The obligation to pay these royalties is contingent on actual sales of the products and in the absence of such sales, no payment is required. Since June 1997, we have paid the Office of the Chief Scientist royalties on all call accounting product sales at the applicable rates at the time of payment. See Item 10E. "Additional Information - Taxation - Grants under the Law for the Encouragement of Industrial Research and Development, 1984."

We have expensed royalties relating to the repayment of the Office of the Chief Scientist grants in the amounts of $198,000, $187,000 and $178,000 for the years ended December 31, 2005, 2006 and 2007, respectively.

As of December 31, 2007, we had a contingent obligation to pay royalties to the Office of the Chief Scientist in the amount of approximately $9.8 million (including a contingent obligation of approximately $1.8 million relating to royalties from revenues derived from products that we acquired from Teleknowledge that were funded by the Office of the Chief Scientist). The $4.4 million of grants received after January 1999 is subject to interest at a rate equal to the 12 month LIBOR rate.

D. TREND INFORMATION

As a result of a less predictable business environment and the decline in worldwide sales of PBX systems, we are unable to provide any guidance as to current sales and profitability trends. We expect that our results will continue to be impacted by a shift to a new line of products and increased marketing and research and development expenditures.

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. TABULAR DISCLOSURE OF CONTRACTUAL OBLIGATIONS

The following table summarizes our minimum contractual obligations and commercial commitments as of December 31, 2007 and the effect we expect them to have on our liquidity and cash flow in future periods.

| Contractual Obligations | Payments due by period | | | | |
|---|---|---|---|---|---|
| | Total | Less than 1 year | 1-3 years | 3-5 years | More than 5 years |
| | (U.S. dollars in thousands) | | | | |
| Operating lease obligations | $ 932 | $ 455 | $ 477 | $ - | $ - |
| Accrued severance pay* | 1,157 | - | - | - | 1,157 |
| Total | $2,089 | $ 455 | $ 477 | $ - | $1,157 |

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* See Item 6D. "Directors, Senior Management and Employees - Employees."



ITEM 6. DIRECTORS, SENIOR MANAGEMENT AND EMPLOYEES

A. DIRECTORS AND SENIOR MANAGEMENT

Set forth below are the name, age, principal position and a biographical description of each of our directors and executive officers:

| NAME | AGE | POSITION WITH THE COMPANY |
|---|---|---|
| Chaim Mer | 60 | Chairman of the Board |
| Eytan Bar | 42 | Chief Executive Officer |
| Lior Salanksy | 43 | President and Director |
| Alon Mualem | 40 | Corporate Chief Financial Officer |
| Isaac Ben-Bassat | 54 | Director |
| Eytan Barak(1) | 63 | Outside Director |
| Dr. Orna Berry (1) | 58 | Outside Director |
| Steven J. Glusband | 61 | Director |

| | | |
|---|---|---|
| Yaacov Goldman (1) | 53 | Director |

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(1) Member of our Audit Committee

Messrs. Mer, Ben-Bassat, Glusband, Goldman and Salansky will serve as directors until our 2008 Annual General Meeting of Shareholders. Mr. Barak and Dr. Berry will serve as outside directors pursuant to the provisions of the Israeli Companies Law for a three-year term until our 2010 annual general meeting of shareholders and January 28, 2011 respectively, following which the service of and the service of Mr. Barrak as an outside director may be renewed for only one additional three-year term and the service of Dr. Berry as an outside director may not be extended.

CHAIM MER has served as Chairman of our Board of Directors and a director since our inception in December 1995. Mr. Mer has been the Chairman of the Board of Directors of C. Mer Industries Ltd., or C. Mer, a publicly traded company, since 1988 and served as its President and Chief Executive Officer from 1988 until January 2005. Mr. Mer holds a B.Sc. degree in Computer Sciences and Mathematics from the Technion - Israel Institute for Technology.

EYTAN BAR has served as our Chief Executive Officer since December 2003 and served as our President from December 2003 to February 2008. Prior to joining our company and from 2001, Mr. Bar served as General Manager of the CEM product division of NICE Systems Ltd. From 2000 through 2001, Mr. Bar served as Vice President of Professional Services at NICE Systems Inc. From 1993 through 1999, Mr. Bar served as General Manager of STS Software Systems Ltd., a company that developed a unique VoIP technology for recording solutions.

LIOR SALANKSY has served as our President since February 2008 and was elected as a director by our Board of Directors on April 2, 2008. In 1991, Mr. Salansky founded MIND C.T.I. Ltd., global provider of real-time, product-based mediation, billing and customer care solutions for voice, data, video and content services, where he served until February 2000 in a number of positions, including Co-Chief Executive Officer, Vice President of Business Development and R&D Manager and also served as a director from its inception until 2004. Mr. Salansky holds a B.Sc. in Computer Science from the Technion, Israel Institute of Technology and an M.B.A. from Tel Aviv University.

ALON MUALEM has served as our Chief Financial Officer since September 2007. Prior to joining our company and from June 2005, Mr. Mualem held the responsibilities of chief financial officer at Xfone, Inc. (AMEX and TASE: XFN), an international communications services company and its subsidiary, Xfone 018 Ltd. Prior to that Mr. Mualem served as chief financial officer of CheckM8, Ltd., a high-tech Internet advertising firm located in Israel. From 1998 to 2004, Mr. Mualem served as the corporate controller of RADVISION Ltd. (NASDAQ: RVSN) and from 1996 to 1998, Mr. Mualem served as a deputy controller of RAD Data Communication Ltd. From 1992 to 1996, Mr. Mualem served as a certified public accountant at Somekh Chaikin, a member firm of KPMG International. Mr. Mualem holds a B.A. degree in Economics and Accounting from Tel Aviv University and is Certified Public Accountant (Israel).



ISAAC BEN-BASSAT has served as a director since our inception in December 1995. Mr. Ben-Bassat has been Executive Vice President and a director of C. Mer Industries Ltd. since 1988. Mr. Ben-Bassat holds a B.Sc. degree in Civil

Engineering from the Technion - Israel Institute for Technology.

EYTAN BARAK has served as an outside director since August 2007 and is a member of our audit committee. Mr. Barak is joint owner and chief executive officer of Dovrat - Barak, Investments in Advanced Technologies Ltd., a company which provides financial resources and management assistance to start-up companies. Mr Barak also serves as a member of the board of directors, audit committee and investment committee of various Israeli companies, including ICTS International N.V. traded on the OTC Bulletin Board (OTCBB: ICTS). From 1973 to 1997, Mr. Barak was with the Israel Corporation Ltd., initially serving as its corporate controller and thereafter as its chief financial officer, and also served as chairman or member of the board of directors of some of its subsidiaries. From 1967 until 1973, Mr. Barak was associated with Kesselman & Kesselman, the Israeli member firm of PricewaterhouseCoopers International Limited. Mr. Barak is a Certified Public Accountant (Israel) since 1971 and holds a B.A. degree in accounting from Tel Aviv University.

DR. ORNA BERRY has served as an outside director since January 2005 and is a member of our audit committee. Dr. Berry is a Venture Partner in Gemini Israel Funds Ltd. and since 2000 has served as Chairperson of Lambda Crossing, Ltd. and Riverhead Networks, Inc., which was sold to Cisco in March 2004. Dr. Berry served as the Chief Scientist of the Ministry of Industry and Trade of the Government of Israel from 1997 to 2000 and Co-President of Ornet Data Communications Technologies Ltd., a provider of high-speed switches, which was acquired by Siemens AG, from 1993 to 1997. From 1992 to 1993, Dr. Berry served as a consultant to Intel Communications Division and Elbit Systems, Ltd. Dr. Berry holds a B.A. degree in statistics and mathematics from Haifa University, M.A. degree in statistics and mathematics from Tel Aviv University and Ph.D. in computer science from the University of Southern California.

STEVEN J. GLUSBAND has served as a director since August 1, 1996. Mr. Glusband has been a partner with Carter Ledyard & Milburn LLP, our U.S. counsel, since March 1987. Mr. Glusband holds a B.B.A. degree from the City College of the City University of New York, a J.D. degree from Fordham University School of Law and an L.L.M. degree from the New York University School of Law.

YAACOV GOLDMAN has served as a director since May 2004 and is a member of our audit committee. Mr. Goldman provides consulting services to companies in strategic-financial areas, through his wholly owned company, Maanit-Goldman Management & Investments (2002) Ltd. Mr. Goldman serves as a director of Bank Leumi Le-Israel Ltd., Elron Electronic Industries Ltd, Golden House Ltd., Tagor capital Ltd. and Renewable Resources Ltd. Mr. Goldman serves as the Professional Secretary of the Peer Review Institute of the Certified Public accountants Institute in Israel. From September 2000 until November 2001, Mr. Goldman served as Managing Director of Argoquest Holdings, LLC, a U.S.-based investment company focused on early stage high-technology companies. From November 1981 until August 2000, Mr. Goldman was associated with Kessleman & Kessleman, the Israeli member firm of PricewaterhouseCoopers, and was a Partner and Senior Partner at such firm from January 1991 through August 2000. Mr. Goldman is a Certified Public Accountant (Israel) since 1981 and holds a B.A. degree in Economics and Accounting from Tel Aviv University.



B. COMPENSATION

The following table sets forth all compensation we paid with respect to all of our directors and executive officers as a group for the year ended December 31, 2007.

| | Salaries, fees, commissions and bonuses | Pension, retirement and similar benefits |
|---|---|---|
| All directors and executive officers as a group (11 persons*) | $589,086 | $75,922 |

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* Inlcudes our former chief executive officer, Shlomi Hagai, who ceased to serve in such capacity in September 2007 and two former directors who ceased to serve in such capacity in June 2007.

All our executive officers work full time for us. Mr. Chaim Mer, the Chairman of our Board of Directors, devotes approximately 20% of his time to the management of our company in consideration of which we pay him a monthly salary of $7,000 per month (as approved by our Audit Committee and Board of Directors on November 8, 1999). We provide automobiles to our executive officers at our expense.

During the year ended December 31, 2007, we paid to our directors an annual fee of approximately $8,400 (three of our directors who served in such capacity for six months during 2007 received approximately $4,200) and a per meeting attendance fee of $300, other than to Mr. Chaim Mer, the Chairman of our Board of Directors and Mr. Yaacov Goldman, an independent director and our financial expert. During the year ended December 31, 2007, we paid Mr. Yaacov Goldman an annual fee of approximately $16,800 and a per meeting attendance fee of $400.

As of December 31, 2007, our directors and executive officers as a group, consisting of 11 persons, held options to purchase an aggregate 330,500 ordinary shares, having exercise prices ranging from $1.23 to $3.87. The options vest over a four-year period. Of such options, options to purchase 320,500 ordinary shares were granted under our 2003 Israeli Share Option Plan (of which, options to purchase 252,500 ordinary shares will expire in December 2008, options to purchase 5,000 ordinary shares will expire in May 2010, options to purchase 30,000 ordinary shares will expire in September 2010, options to purchase 3,000 ordinary shares will expire on March 2011 and options to purchase 30,000 ordinary shares will expire on September 2012) and options to purchase 10,000 ordinary shares were granted under our 1996 Stock Option Plan (all of which will expire in December 2008). See Item 6.E., "Directors, Senior Management and Employees - Share Ownership - Stock Option Plans."

C. BOARD PRACTICES

ELECTION OF DIRECTORS

Our Articles of Association provide for a Board of Directors consisting of up to ten members or such other number as may be determined from time to time at a general meeting of shareholders. Our Board of Directors is currently composed of seven directors.

Pursuant to our articles of association, all of our directors (except the outside directors) are elected at our annual general meeting of shareholders by a vote of the holders of a majority of the voting power represented and voting at such meeting and hold office until the next annual general meeting of shareholders and until their successors have been elected. The Board of Directors, may, at any time from time to time, appoint any other person as a director, whether to fill a casual vacancy or to add to their number. All the members of our Board of Directors (except the outside directors) may be reelected upon completion of their term of office. All of our current directors (except our outside directors) were elected by our shareholders at our annual

general meeting of shareholders held in August 2007, other than Mr. Lior Salansky who was elected as a director by our Board of Directors on April 2, 2008.

We do not follow the requirements of the NASDAQ Marketplace Rules with regard to the nomination process of directors, and instead, we follow Israeli law and practice, in accordance with which our directors are recommended by our board of directors for election by our shareholders. See below in this Item 6C. "Directors, Senior Management and Employees - Board Practices - NASDAQ Marketplace Rules and Home Country Practices."



OUTSIDE AND INDEPENDENT DIRECTORS

OUTSIDE DIRECTORS. Under the Israeli Companies Law, companies incorporated under the laws of the State of Israel whose shares have been offered to the public are required to appoint at least two outside directors. The Israeli Companies Law provides that a person may not be appointed as an outside director if the person, or the person's relative, partner, employer or an entity under that person's control, has or had during the two years preceding the date of appointment any affiliation with the company, or any entity controlling, controlled by or under common control with the company. The term "relative" means a spouse, sibling, parent, grandparent, child or child of spouse or spouse of any of the above. The term affiliation includes:

- an employment relationship;
- a business or professional relationship maintained on a regular basis;
- control; and
- service as an officer holder, excluding service as an outside director of a company that is offering its shares to the public for the first time.

In addition, no person may serve as an outside director if the person's position or other activities create, or may create, a conflict of interest with the person's responsibilities as director or may otherwise interfere with the person's ability to serve as director. If, at the time an outside director is appointed all members of the board of directors are of the same gender, then that outside director must be of the other gender. A director of one company may not be appointed as an outside director of another company if a director of the other company is acting as an outside director of the first company at such time.

At least one of the outside directors elected must have "accounting and financial expertise" and any other outside director must have "accounting and financial expertise" or "professional qualification," as such terms are defined by regulations promulgated under the Israeli Companies Law.

Outside directors are elected by shareholders. The shareholders voting in favor of their election must include at least one-third of the shares of the non-controlling shareholders of the company who voted on the matter. This minority approval requirement need not be met if the total shareholdings of those non-controlling shareholders who vote against their election represent 1% or less of all of the voting rights in the company.

In general, outside directors serve for a three-year term, which may be renewed for only one additional three-year term. Outside directors can be

removed from office only by the same special percentage of shareholders as can elect them, or by a court, and then only if the outside directors cease to meet the statutory qualifications with respect to their appointment or if they violate their duty of loyalty to the company.

Any committee of the board of directors must include at least one outside director and the audit committee must include all of the outside directors. An outside director is entitled to compensation as provided in regulations adopted under the Israeli Companies Law and is otherwise prohibited from receiving any other compensation, directly or indirectly, in connection with such service.

INDEPENDENT DIRECTORS. In general, NASDAQ Marketplace Rules require that a majority of our board of directors qualify as independent directors within the meaning of the NASDAQ Marketplace Rules and our audit committee must have at least three members and be comprised only of independent directors each of whom satisfies the respective "independence" requirements of the Securities and Exchange Commission and NASDAQ.



Our Board of Directors has determined that Mr. Eytan Barak and Dr. Orna Berry both qualify as independent directors under the rules of the Securities and Exchange Commission and NASDAQ and as outside directors under the requirements of the Israeli Companies Law. Our Board of Directors has further determined that Messrs. Steven Glusband and Yaacov Goldman qualifies as an independent director under the requirements of the Securities and Exchange Commission and NASDAQ.

AUDIT COMMITTEE

Our audit committee, which was established in accordance with Section 114 of the Israeli Companies Law and Section 3(a)(58)(A) of the Securities Exchange Act of 1934, assists our board of directors in overseeing the accounting and financial reporting processes of our company and audits of our financial statements, including the integrity of our financial statements, compliance with legal and regulatory requirements, our independent public accountants' qualifications and independence, the performance of our internal audit function and independent public accountants, finding any defects in the business management of our company and proposing to the board of directors ways to correct such defects, and such other duties as may be directed by our board of directors.

The responsibilities of the audit committee also include approving related-party transactions as required by law. Under Israeli law an audit committee may not approve an action or a transaction with a controlling shareholder, or with an office holder, unless at the time of approval two outside directors are serving as members of the audit committee and at least one of the outside directors was present at the meeting in which an approval was granted.

Our audit committee consists of three members of our Board of Directors who satisfy the respective "independence" requirements of the Securities and Exchange Commission, NASDAQ and Israeli Law for audit committee members. Our audit committee is currently composed of Mr. Eytan Barak, Dr. Orna Berry and Mr.Yaacov Goldman. Our Board of Directors has determined that Mr. Goldman qualifies as a financial expert. The audit committee meets at least once each quarter.

INTERNAL AUDIT

Under the Israeli Companies Law, the board of directors of a public company must appoint an internal auditor nominated by the audit committee. A person who does not satisfy the Israeli Companies Law's independence requirements may not be appointed as an internal auditor. The role of the internal auditor is to examine, among other things, the compliance of the company's conduct with applicable law and orderly business practice. Mr. Shaul Sofer, Certified Public Accountant (Israel), serves as our internal auditor.

DIRECTORS' SERVICE CONTRACTS

We do not have any service contracts with our directors. There are no arrangements or understandings between us and any of our subsidiaries, on the one hand, and any of our directors, on the other hand, providing for benefits upon termination of their employment or service as directors of our company or any of our subsidiaries.

APPROVAL OF RELATED PARTY TRANSACTIONS UNDER ISRAELI LAW

FIDUCIARY DUTIES OF OFFICE HOLDERS

The Israeli Companies Law codifies the fiduciary duties that "office holders," including directors and executive officers, owe to a company. An "office holder" is defined in the Israeli Companies Law as a director, general manager, chief business manager, deputy general manager, vice general manager, other manager directly subordinate to the general manager or any other person assuming the responsibilities of any of the foregoing positions without regard to such person's title. An office holder's fiduciary duties consist of a duty of care and a duty of loyalty. The duty of care requires an office holder to act at a level of care that a reasonable office holder in the same position would employ under the same circumstances. This includes the duty to utilize reasonable means to obtain (i) information regarding the appropriateness of a given action brought for his approval or performed by him by virtue of his position and (ii) all other information of importance pertaining to the foregoing actions. The duty of loyalty includes (i) avoiding any conflict of interest between the office holder's position in the company and any other position he holds or his personal affairs, (ii) avoiding any competition with the company's business, (iii) avoiding exploiting any business opportunity of the company in order to receive personal gain for the office holder or others, and (iv) disclosing to the company any information or documents relating to the company's affairs that the office holder has received due to his position as an office holder.



DISCLOSURE OF PERSONAL INTERESTS OF AN OFFICE HOLDER

The Israeli Companies Law requires that an office holder promptly, and no later than the first board meeting at which such transaction is considered, disclose any personal interest that he or she may have and all related material information known to him or her and any documents in their position, in connection with any existing or proposed transaction by us. In addition, if the transaction is an extraordinary transaction, that is, a transaction other than in the ordinary course of business, other than on market terms, or likely to have a material impact on the company's profitability, assets or liabilities, the office holder must also disclose any personal interest held by the office holder's spouse, siblings, parents, grandparents, descendants, spouse's descendants and the spouses of any of the foregoing, or by any corporation in which the office holder or a relative is a 5% or greater shareholder, director

or general manager or in which he or she has the right to appoint at least one director or the general manager.

APPROVAL OF TRANSACTIONS WITH OFFICE HOLDERS

Under the Israeli Companies Law, all arrangements as to compensation of office holders who are not directors require approval by the board of directors, and exculpation, insurance and indemnification of, or an undertaking to, indemnify an office holder who is not a director requires both board of directors and audit committee approval. The compensation of office holders who are directors must be approved by our audit committee, board of directors and shareholders.

Some transactions, actions and arrangements involving an office holder (or a third party in which an office holder has an interest) must be approved by the board of directors or as otherwise provided for in a company's articles of association, however, a transaction that is adverse to the company's interest may not be approved. In some cases, such a transaction must be approved by the audit committee and by the board of directors itself, and under certain circumstances shareholder approval may be required. A director who has a personal interest in a transaction that is considered at a meeting of the board of directors or the audit committee may not be present during the board of directors or audit committee discussions and may not vote on the transaction, unless the transaction is not an extraordinary transaction or the majority of the members of the board or the audit committee have a personal interest, as the case may be. In the event the majority of the members of the board of directors or the audit committee have a personal interest, then the approval of the general meeting of shareholders is also required.

DISCLOSURE OF PERSONAL INTERESTS OF A CONTROLLING SHAREHOLDER; APPROVAL OF TRANSACTIONS WITH CONTROLLING SHAREHOLDERS

The disclosure requirements which apply to an office holder also apply to such transaction with respect to his or her personal interest in the transaction. The Israeli Companies Law provides that an extraordinary transaction with a controlling shareholder or an extraordinary transaction with another person in whom the controlling shareholder has a personal interest or a transaction with a controlling shareholder or his relative regarding terms of service and employment, must be approved by the audit committee, the board of directors and shareholders. The shareholder approval for such a transaction must include at least one-third of the shareholders who have no personal interest in the transaction who voted on the matter (not including abstentions). The transaction can be approved by shareholders without this one-third approval if the total shareholdings of those shareholders who have no personal interest and voted against the transaction do not represent more than one percent of the voting rights in the company.



Under the Companies Regulations (Relief from Related Party Transactions), 5760-2000, promulgated under the Israeli Companies Law, as amended, certain extraordinary transactions between a public company and its controlling shareholder(s) do not require shareholder approval. In addition, under such regulations, directors' compensation and employment arrangements in a public company do not require the approval of the shareholders if both the audit committee and the board of directors agree that such arrangements are solely for the benefit of the company. Also, employment and compensation arrangements for an office holder that is a controlling shareholder of a public company do not require shareholder approval if certain criteria are met. The foregoing

exemptions from shareholder approval will not apply if one or more shareholders holding at least 1% of the issued and outstanding share capital of the company or of the company's voting rights, objects to the use of these exemptions provided that such objection is submitted to the company in writing not later than fourteen days from the date of the filing of a report regarding the adoption of such resolution by the company pursuant to the requirements of the Israeli Securities Law. If such objection is duly and timely submitted, then the transaction or compensation arrangement of the directors will require shareholders' approval as detailed above.

In addition, a private placement of securities that will (i) cause a person to become a controlling shareholder or (ii) increase the relative holdings of a shareholder that holds 5% or more of the company's outstanding share capital, or (iii) will cause any person to become, as a result of the issuance, a holder of more than 5% of the company's outstanding share capital in a private placement in which 20% or more of the company's outstanding share capital prior to the placement are offered, the payment for which (in whole or in part) is not in cash or not under market terms, requires approval by the board of directors and the shareholders of the company.

The Israeli Companies Law provides that an acquisition of shares in a public company must be made by means of a tender offer if as a result of the acquisition the purchaser would become a 25% or greater shareholder of the company. This rule does not apply if there is already another 25% or greater shareholder of the company. Similarly, the Israeli Companies Law provides that an acquisition of shares in a public company must be made by means of a tender offer if as a result of the acquisition the purchaser would hold greater than a 45% interest in the company, unless there is another shareholder holding more than a 45% interest in the company. These requirements do not apply if, in general, the acquisition was made in a private placement that received shareholder approval, (i) was from a 25% or greater shareholder of the company which resulted in the acquirer becoming a 25% or greater shareholder of the company, if there is not already a 25% or greater shareholder of the company, or (ii) was from a shareholder holding a 45% interest in the company which resulted in the acquirer becoming a holder of a 45% interest in the company if there is not already a 45% or greater shareholder of the company.

If, as a result of an acquisition of shares, the acquirer will hold more than 90% of a public company's outstanding shares or a class of shares, the acquisition must be made by means of a tender offer for all of the outstanding shares or a class of shares. If less than 5% of the outstanding shares are not tendered in the tender offer, all the shares that the acquirer offered to purchase will be transferred to the acquirer. The Israeli Companies Law provides for appraisal rights if any shareholder files a request in court within three months following the consummation of a full tender offer. If more than 5% of the outstanding shares are not tendered in the tender offer, then the acquirer may not acquire shares in the tender offer that will cause his shareholding to exceed 90% of the outstanding shares.

EXCULPATION, INDEMNIFICATION AND INSURANCE OF DIRECTORS AND OFFICERS

EXCULPATION OF OFFICE HOLDERS. The Israeli Companies Law provides that an Israeli company cannot exculpate an office holder from liability with respect to a breach of his or her duty of loyalty. If permitted by its articles of association, a company may exculpate in advance an office holder from his or her liability to the company, in whole or in part, with respect to a breach of his or her duty of care. However, a company may not exculpate in advance a director from his or her liability to the company with respect to a breach of his duty of care in the event of distributions.

INSURANCE OF OFFICE HOLDERS. Israeli law provides that a company may, if permitted by its articles of association, enter into a contract to insure its office holders for liabilities incurred by the office holder with respect to an act or omission performed in his or her capacity as an office holder, as a result of: (i) a breach of the office holders duty of care to the company or another person; (ii) a breach of office holders duty of loyalty to the company, provided that the office holder acted in good faith and had reasonable cause to assume that the act would not prejudice the company's interests; and (iii) a financial liability imposed upon the office holder in favor of another person.

INDEMNIFICATION OF OFFICE HOLDERS. Under Israeli law a company may, if permitted by its articles of association, indemnify an office holder for acts or omissions performed by the office holder in such capacity for (a) monetary liability imposed upon the office holder in favor of another person pursuant to a court judgment, including a settlement or an arbitration award approved by a court; (b) reasonable litigation expenses, including attorney's fees, actually incurred by the office holder as a result of an investigation or proceeding instituted against him or her by a competent authority, provided that such investigation or proceeding concluded without the filing of an indictment against the office holder or the imposition of any monetary liability in lieu of criminal proceedings, or concluded without the filing of an indictment against the office holder and a monetary liability was imposed on him or her in lieu of criminal proceedings with respect to a criminal offense that does not require proof of criminal intent; and (c) reasonable litigation expenses, including attorneys' fees, actually incurred by the office holder or imposed upon the office holder by a court: (i) in an action, suit or proceeding brought against the office holder by or on behalf of the company or another person, (ii) in connection with a criminal action in which the office holder was acquitted, or (iii) in connection with a criminal action in which the office holder was convicted of a crime that does not require proof of criminal intent.

Israeli law provides that a company's articles of association may permit the company to (a) indemnify an office holder retroactively, following a determination to this effect made by the company after the occurrence of the event in respect of which the office holder will be indemnified; and (b) undertake in advance to indemnify an office holder, except that with respect to a monetary liability imposed on the office holder by any judgment, settlement or court-approved arbitration award, the undertaking must be limited to types of occurrences, which, in the opinion of the company's board of directors, are, at the time of the undertaking, foreseeable due to the company's activities and to an amount or standard that the board of directors has determined is reasonable under the circumstances.

LIMITATIONS ON EXCULPATION, INSURANCE AND INDEMNIFICATION. These provisions are specifically limited in their scope by Israeli law, which provides that a company may not indemnify an office holder, nor exculpate an office holder, nor enter into an insurance contract which would provide coverage for any monetary liability, incurred as a result of certain improper actions.

The term "office holder" of a company includes a director, general manager, chief business manager, deputy general manager, vice general manager, or any person filling any of these positions in a company even if he or she holds a different title, and also includes any other manager directly subordinate to the general manager.

Pursuant to the Israeli Companies Law, exculpation of, procurement of insurance coverage for, and an undertaking to indemnify or indemnification of, our office holders must be approved by our audit committee and our board of directors and, if the office holder is a director, also by our shareholders.

Our Articles of Association allow us to insure, indemnify and exempt our office holders, to the fullest extent permitted by the provisions of the Israeli Companies Law. We maintain a directors' and officers' liability insurance policy with a per claim and aggregate coverage limit of $5 million, including legal costs incurred in Israel. We have provided several of our directors and officers a letter of indemnification for liabilities or expenses incurred as a result of their acts in their capacity as directors and officers of our company, in an aggregate amount not to exceed $3 million.



NASDAQ MARKETPLACE RULES AND HOME COUNTRY PRACTICES

Under NASDAQ Marketplace Rule 4350, or Rule 4350, foreign private issuers, such as our company, are permitted to follow certain home country corporate governance practices instead of certain provisions of Rule 4350. A foreign private issuer that elects to follow a home country practice instead of any of such provisions of Rule 4350, must submit to NASDAQ, in advance, a written statement from an independent counsel in such issuer's home country certifying that the issuer's practices are not prohibited by the home country's laws.

On June 21, 2005, we provided NASDAQ with a notice of non-compliance with Rule 4350 with respect to the requirements regarding the directors' nominations process. Instead, we follow Israeli law and practice in accordance with which our directors are recommended by our board of directors for election by our shareholders. See above in this Item 6C. "Directors, Senior Management and Employees - Board Practices - Election of Directors."

D. EMPLOYEES

On December 31, 2007, we and our consolidated subsidiaries employed 75 persons, of which 28 persons were employed in research and development, 18 in training and technical support, 12 in sales and marketing and 17 in operations and administration. As of December 31, 2007, 41 of our employees were located in Israel, 20 of our employees were located in the United States, 4 of our employees were located in Hong Kong and 10 of our employees were located in Brazil.

On December 31, 2006, we and our consolidated subsidiaries employed 104 persons, of which 37 persons were employed in research and development, 29 in training and technical support, 20 in sales and marketing and 18 in operations and administration. As of December 31, 2006, 60 of our employees were located in Israel, 30 of our employees were located in the United States, 4 of our employees were located in Hong Kong and 10 of our employees were located in Brazil.

On December 31, 2005, we and our consolidated subsidiaries employed 124 persons, of which 58 persons were employed in research and development, 30 in training and technical support, 18 in sales and marketing and 18 in operations and administration. As of December 31, 2005, 85 of our employees were located in Israel, 23 of our employees were located in the United States, 5 of our employees were located in Hong Kong, 1 of our employees was located in Holland and 10 of our employees were located in Brazil.

Certain provisions of the collective bargaining agreements between the Histadrut (General Federation of Labor in Israel) and the Coordination Bureau of Economic Organizations (including the Industrialists Association) are applicable to our employees by order of the Israeli Ministry of Labor. These provisions

concern mainly the length of the workday, minimum daily wages for professional workers, contributions to a pension fund, insurance for work-related accidents, procedures for dismissing employees, determination of severance pay and other conditions of employment. We generally provide our employees with benefits and working conditions beyond the required minimums.

Cost of living adjustment of employees' wages are determined on a nationwide basis and are legally binding, if and when applied. Israeli employers and employees are required to pay predetermined amounts to the National Insurance Institute, which is similar to the United States Social Security Administration. In 2007, payments to the National Insurance Institute amounted to approximately 15.2% of wages, of which approximately two-thirds was contributed by employees with the balance contributed by the employer.

Pursuant to Israeli law, we are legally required to pay severance benefits upon certain circumstances, including the retirement or death of an employee or the termination of employment of an employee without due cause. We partly satisfy this obligation by contributing approximately 8.3% of between 80%-100% of the employee's annual gross salary to a fund known as "Managers' Insurance" or to pension fund. This fund provides a combination of savings plans, insurance and severance pay benefits to the employee, giving the employee a lump sum payment upon retirement and a severance payment, if legally entitled, upon termination of employment. The remaining part of this obligation is presented in our balance sheet as the difference between the "accrued severance pay" and "severance pay fund."



E. SHARE OWNERSHIP

The following table sets forth certain information as of April 7, 2008 regarding the beneficial ownership of our ordinary shares by each of our directors and executive officers.

| Name | Number of Ordinary Shares Beneficially Owned(1) | Percentage of Outstanding Ordinary Shares(2) |
|---|---|---|
| Chaim Mer | 2,023,954 (3) | 31.0% |
| Eytan Bar | 318,809 (4) | 4.7% |
| Lior Salansky | 1,052,484 (5) | 16.1% |
| Alon Mualem | -- | -- |
| Isaac Ben-Bassat | 689,214 (6) | 10.6% |
| Eytan Barak | -- | -- |
| Dr. Orna Berry | -- | -- |
| Steven J. Glusband | 11,000 (7) | * |
| Yaacov Goldman | -- | -- |

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* Less than 1%.

(1) Beneficial ownership is determined in accordance with the rules of the Securities and Exchange Commission and generally includes voting or investment power with respect to securities. Ordinary shares relating to options currently exercisable or exercisable within 60 days of the date of this table are deemed outstanding for computing the percentage of the person holding such securities but are not deemed outstanding for computing

the percentage of any other person. Except as indicated by footnote, and subject to community property laws where applicable, the persons named in the table above have sole voting and investment power with respect to all shares shown as beneficially owned by them.

(2) The percentages shown are based on 6,523,845 ordinary shares (excluding 10,800 ordinary shares held as treasury stock) issued and outstanding as of April 7, 2008.

(3) Mr. Chaim Mer and his wife, Mrs. Dora Mer, are the holders of 308,867 ordinary shares, and are the beneficial owners of 1,703,453 ordinary shares through their controlling interest in Mer Ofekim Ltd., 11,539 ordinary shares through their controlling interest in Mer Services Ltd. and 95 ordinary shares through their controlling interest in Mer & Co. (1982) Ltd.

(4) Includes 250,000 ordinary shares subject to currently exercisable stock options that have an exercise price of $1.84 per share and expire on December 2008; 10,000 ordinary shares subject to currently exercisable stock options that have an exercise price of $3.87 per share and expire on September 2010; and 5,600 ordinary shares subject to currently exercisable warrants that have an exercise price of $4.00 per share and expire on August 10, 2009.

(5) Based upon a Schedule 13D filed with the Securities and Exchange Commission on February 21, 2008 and other information available to the company. Includes 10,424 ordinary shares subject to currently exercisable warrants that have an exercise price of $4.00 per share and expire on August 10, 2009.



(6) Includes 630,045 ordinary shares held by Ron Dan Investments Ltd., a corporation controlled by Mr. Ben-Bassat.

(7) Includes 10,000 ordinary shares subject to currently exercisable stock options that have an exercise price of $2.90 per share and expire on December 2008.

STOCK OPTION PLANS

1996 STOCK OPTION PLAN

Under our 1996 Stock Option Plan, as amended, or the 1996 Plan, options to purchase up to 400,000 ordinary shares were issuable under options granted to our employees, management, officers and directors or those of our subsidiaries. Any options which are canceled or forfeited within the option period became available for future grants. The 1996 Plan terminated on May 31, 2006.

The 1996 Plan provides that it is administered by the Board of Directors or an Option Committee which may be appointed by the Board of Director. The exercise price of options granted under the 1996 Plan may not be less than 100% of the fair market value of our ordinary shares on the date of the grant of incentive stock options and 75% in the case of options not designated as incentive stock options. Fair market value is the mean between the highest and lowest quoted selling prices on the date of grant of our shares traded on NASDAQ or a stock exchange on which such shares are principally traded.

Options granted under the 1996 Plan are generally exercisable under such circumstances as the Board or Option Committee determines. Such options are not

transferable by an optionee other than by will or by laws of descent and distribution, and during an option holder's lifetime are exercisable only by such option holder or by his or her legal representative. Options granted under the 1996 Plan terminate at such time and under such circumstances as the Board or Option Committee determines.

During 2007, no options were granted under the 1996 Plan and no options were exercised into ordinary shares. At December 31, 2007, options to purchase 62,100 ordinary shares were outstanding under the 1996 Plan, exercisable at an average exercise price of $3.44 per share.

1996 SECTION 102 STOCK OPTION PLAN

In 1996, we adopted a Section 102 Stock Option Plan, as amended, or the 1996 102 Plan, providing for the grant of options to our Israeli employees, management, officers and directors or those of our subsidiaries. The 1996 102 Plan was adopted pursuant to Section 102 of the Israeli Income Tax Ordinance [New Version] - 1961, or Section 102, and provided recipients with tax advantages under the Israeli Income Tax Ordinance. As of January 1, 2003, Section 102 was amended, pursuant to which certain new tax advantages are afforded with respect to option grants to employees and directors. In order to enable employees and directors to benefit from such tax advantages with respect to future grants of options and issuance of shares upon exercise thereof, such grants have to be performed under a share option plan that is adjusted to the amended Section 102, and therefore we adopted our 2003 Israeli Share Option Plan. Upon the adoption of our 2003 Israeli Share Option Plan, we did not intend to grant any more options under the 1996 102 Plan and the ordinary shares that remained available for grant under the 1996 102 Plan were rolled-over into our 2003 Israeli Share Option Plan for issuance thereunder. The 1996 102 Plan terminated on May 31, 2006.

Options granted under our 1996 102 Plan are exercisable under such circumstances as the Board of Directors or Option Committee determined. Options granted under the this plan are not transferable by an optionee other than by will or by laws of descent and distribution, and during an option holder's lifetime will be exercisable only by such option holder or by his or her legal representative.

During 2007, no options were granted under the 1996 102 Plan and no options were exercised into ordinary shares. At December 31, 2007, no options were outstanding under the 1996 102 Plan.



2003 ISRAELI SHARE OPTION PLAN

Under our 2003 Israeli Share Option Plan, or the 2003 Plan, options to purchase up to 893,915 ordinary shares may be granted to directors, employees, consultants, advisors, service providers, controlling shareholders and other persons not employed by us or by our affiliates. Any options which are canceled or forfeited within the option period will become available for future grants. The 2003 Plan will terminate in 2013, unless earlier terminated by the Board of Directors.

Options to Israeli employees, directors and officers, other than controlling shareholders (as such term is defined in the Israeli Income Tax Ordinance), under the 2003 Plan may only be granted under Section 102. Under amended Section 102, options granted pursuant to Section 102 may be designated as "Approved 102 Options" or "Unapproved 102 Options." An Approved 102 Option

may either be classified as a capital gains option or an ordinary income option. We elected to initially grant our options pursuant to Section 102 as capitals gain options. Such election is effective as of the first date of grant of such capital gains options under the 2003 Plan and shall remain in effect at least until the lapse of one year following the end of the tax year during which we first granted capital gains options. All Approved 102 Options (or the ordinary shares issued upon exercise thereof) must be held in trust by a trustee for the requisite holding period under Section 102 in order to benefit from the certain tax advantages. We may also grant Unapproved 102 Options, which do not have any tax benefit and are not held by a trustee. Options granted under Section 102 are taxed on the date of sale of the exercised ordinary shares and/or the date of the release of the options or such exercised ordinary shares from the trust.

The 2003 Plan is administered by the Board of Directors or a committee of the Board of Directors, if appointed, which has the authority, subject to applicable law, to determine, the persons to whom options will be granted, the terms and conditions of the respective options, including the time and the extent to which the options may be exercised, may designate the type of options, make an election as to the type of Approved 102 Option. The exercise price of options granted under the 2003 Plan will be based on the fair market value of our ordinary shares and is determined by the Board of Directors or the committee at the time of the grant.

Options granted under the 2003 Plan are not assignable or transferable by an optionee, other than by will or by laws of descent and distribution, and during the lifetime of an optionee may be exercised only by the optionee or by the optionee's legal representative. Such options may be exercised as long as the optionee is employed by, or providing services to us or any of our affiliates, to the extent the options have vested.

During 2007, options to purchase an aggregate of 90,000 ordinary shares were granted under the 2003 Plan at an average exercise price of $1.23 per share, and no options were exercised. At December 31, 2007, options to purchase 594,500 ordinary shares were outstanding under the 2003 Plan, exercisable at an average exercise price of $2.36 per share.

2006 STOCK OPTION PLAN

In June 2006, we adopted our 2006 Stock Option Plan, or the 2006 Plan, under which up to 400,000 ordinary shares may be issued (subject to standard adjustments) to employees, officers and non-employee directors of ours and our affiliates. Ordinary shares as to which an option granted under the 2006 Plan has not been exercised at the time of its expiration, cancellation or forfeiture may again be subject to new awards under the 2006 Plan. The total number of ordinary shares with respect to which options may be granted to any eligible employee during any period of 12 consecutive months may not exceed 100,000 ordinary shares (subject to adjustment as provided in the 2006 Plan).

The 2006 Plan will be administered by our Board of Directors or to the extent permitted by Israeli law, a Compensation Committee of our Board of Directors, if established by our Board of Directors at its discretion. All references below to the "Committee" refers to the Board of Directors or compensation committee established by our Board of Directors, as applicable. The Committee will have the authority, in its discretion, to establish from time to time guidelines or regulations for the administration of the 2006 Plan, to interpret the 2006 Plan, and to make all determinations it considers necessary or advisable for the administration of the 2006 Plan, in addition to the other responsibilities and powers assigned to the Committee in the 2006 Plan. All decisions, actions or interpretations of the Committee under the 2006 Plan will be final, conclusive and binding upon all parties.

Each option granted under the 2006 Plan will be either an option intended to be treated as an "incentive stock option," within the meaning of Section 422 of the Internal Revenue Code of 1986, as amended, or the Code, or an option that will be treated as a "non-qualified stock option." No incentive stock may be granted to any individual who is not an eligible employee of our company or a "subsidiary" within the meaning of the Code. No incentive stock option may be granted to an employee if, as of the date of grant of such option, such employee owns stock possessing more than ten percent of the total combined voting power of all classes of stock of our company or any affiliated company, a "10% Holder," unless (a) the exercise price per share under such option is at least 110% of the fair market value of an ordinary share determined as of the date of grant of such option, and (b) such option is not exercisable after the expiration of five years from the date of grant of such option. No incentive stock option may be granted under the 2006 Plan after the ten year anniversary of its adoption.

In no event may the term of any option exceed ten years from the date of grant of the option. However, in no event may the term of any option granted to a 10% Holder exceed five years from the date of grant of the option. No option may be exercised after its expiration.

Each option granted under the 2006 Plan will become exercisable, in whole or in part, at such time or times during its term as the instrument evidencing the grant of such option may specify.

The price at which ordinary shares may be purchased upon any exercise of an option granted under the 2006 Plan will be the price per share determined by the Committee, and specified in the instrument evidencing the grant of such option, but in no event may the exercise price per share be less than (i) the fair market value of an ordinary share determined as of the date of grant of the option, or (ii), if greater, the par value of an ordinary share. However, with respect to an option granted to a 10% Holder, in no event may the exercise price per share be less than 110% of the fair market value of our ordinary shares determined as of the date of grant of such option.

Options granted under the 2006 Plan are nontransferable, other than by will or the laws of descent and distribution, and may be exercised during the grantee's lifetime only by the grantee. However, if the instrument evidencing the grant of an option other than an incentive stock option so provides, the grantee may transfer his or her rights with respect to such option or any portion thereof, without consideration, to any "family member," as such term is defined in the 2006 Plan.

The terms and conditions of an option grant may not be waived or amended without the consent of the grantee if it would adversely affect, to any material extent, any of the rights or obligations of the grantee with respect to such grant, or in the case of any option that was intended to constitute an incentive stock option, if such waiver or amendment would cause such option to fail to be treated as an incentive stock option.

Our Board of Directors may, with prospective or retroactive effect, amend, suspend or terminate the 2006 Plan or any portion of the 2006 Plan at any time. However, no amendment, suspension or termination of the 2006 Plan may adversely affect the rights of any grantee with respect to any options previously granted to the grantee without his or her written consent. Also, no amendment which constitutes a "material revision" of the 2006 Plan, as the term material revision is defined in the applicable rules of the National Association of Securities Dealers, may be effective unless approved by our shareholders in the

manner required by such rules and by applicable law.

During 2007, options to purchase an aggregate of 20,000 ordinary shares were granted under the 2006 Plan at an average exercise price of $1.23 per share, and no options were exercised. At December 31, 2007, options to purchase 20,000 ordinary shares were outstanding under the 2006 Plan, exercisable at an average exercise price of $1.23 per share.



WARRANTS

On August 3, 2005, we issued a warrant to purchase 37,000 ordinary shares to Mr. Avraham Ziv in connection with financial services that he provided to our company. The warrant has an exercise price of $4.00 per share, subject to anti-dilution adjustments, and is exercisable from February 3, 2006 until August 3, 2009. Mr. Ziv provided financial services to us from to time during the last five years.

In connection with our August 2005 private placement to institutional and private investors, we issued to the investors warrants to purchase an aggregate 375,000 ordinary shares at an exercise price of $4.00 per share (subject to anti-dilution adjustments), exercisable from February 10, 2006 until August 10, 2009.

ITEM 7. MAJOR SHAREHOLDERS AND RELATED PARTY TRANSACTIONS

A. MAJOR SHAREHOLDERS

The following table sets forth certain information as of April 7, 2008 regarding the beneficial ownership by all shareholders known to us to own beneficially 5.0% or more of our ordinary shares:

| Name | Number of Ordinary Shares Beneficially Owned(1) | Percentage of Outstanding Ordinary Shares(2) |
|---|---|---|
| Chaim Mer and Dora Mer | 2,023,954 (3) | 31.0% |
| Lior Salanksy | 1,052,484 (4) | 16.1% |
| Roni Ben David | 764,963 (5) | 11.7% |
| Isaac Ben-Bassat | 689,214 (6) | 10.6% |

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(1) Beneficial ownership is determined in accordance with the rules of the Securities and Exchange Commission and generally includes voting or investment power with respect to securities. Ordinary shares relating to options currently exercisable or exercisable within 60 days of the date of this table are deemed outstanding for computing the percentage of the person holding such securities but are not deemed outstanding for computing the percentage of any other person. Except as indicated by footnote, and subject to community property laws where applicable, the persons named in the table above have sole voting and investment power with respect to all shares shown as beneficially owned by them.

(2) The percentages shown are based on 6,523,845 ordinary shares (excluding 10,800 ordinary shares held as treasury stock) issued and outstanding as of April 7, 2008.

(3) Mr. Chaim Mer and his wife, Mrs. Dora Mer, are the holders of 159,971 ordinary shares, and are the beneficial owners of 1,703,453 ordinary shares through their controlling interest in Mer Ofekim Ltd., 11,539 ordinary shares through their controlling interest in Mer Services Ltd. and 95 ordinary shares through their controlling interest in Mer & Co. (1982) Ltd.

(4) Based upon a Schedule 13D filed with the Securities and Exchange Commission on February 21, 2008 and other information available to the company. Inlcudes 10,424 ordinary shares subject to currently exercisable warrants that have an exercise price of $4.00 per share and expire on August 10, 2009.

(5) Based solely upon, and qualified in its entirety with reference to, a Schedule 13G filed with the Securities and Exchange Commission on February 6, 2008.

(6) Includes 630,045 ordinary shares held by Ron Dan Investments Ltd., a corporation controlled by Mr. Ben-Bassat.



SIGNIFICANT CHANGES IN THE OWNERSHIP OF MAJOR SHAREHOLDERS

On February 11, 2008, we issued in a private placement 750,000 ordinary shares to Mr. Lior Salanksy at a price per share of $1.0 and for a total consideration of $750,000. On February 21, 2008, Mr. Lior Salanksy filed a Schedule 13D with the Securities and Exchange Commission reflecting ownership of 1,042,060, or 15.97%, of our ordinary shares

MAJOR SHAREHOLDERS VOTING RIGHTS

Our major shareholders do not have different voting rights

RECORD HOLDERS

Based on a review of the information provided to us by our transfer agent, as of April 2, 2008, there were 37 holders of record of our ordinary shares, of which six record holders holding approximately 41.80% of our ordinary shares had registered addresses in the United States. These numbers are not representative of the number of beneficial holders of our shares nor are they representative of where such beneficial holders reside, since many of these ordinary shares were held of record by brokers or other nominees (including one U.S. nominee company, CEDE & Co., which held approximately 41.78% of our outstanding ordinary shares as of such date).

B. RELATED PARTY TRANSACTIONS

Ms. Dora Mer, the wife of Chaim Mer, provides legal services to us and receives a monthly retainer of $5,000. The conditions of retaining the services of Ms. Mer were approved by our Board of Directors and Audit Committee.

Our subsidiaries, MTS Asia Ltd. and MTS IntegraTRAK, entered into an agreement with C. Mer Industries Ltd., or C. Mer, pursuant to which they distribute and support certain of C. Mer's products and provide certain services on behalf of C. Mer. Generally, C. Mer compensates MTS Asia Ltd. for these activities at cost plus 10% and compensates MTS IntegraTRAK at cost plus 5%. C. Mer is a publicly traded company controlled by Mr. Chaim Mer, and Mr. Mer has

been the Chairman of its Board of Directors since 1988 and served as its President and Chief Executive Officer from 1988 until January 2005. Presently, the only service provided to us by C. Mer is our participation in its umbrella liability insurance coverage. We believe that the terms under which C. Mer provides such participation to us is on a basis no less favorable than could be obtained from an unaffiliated third party.

On August 10, 2005, we entered into definitive agreements with institutional and private investors, including our Chief Executive Officer, Mr. Eytan Bar, for a private placement of ordinary shares and warrants to purchase ordinary shares that raised $2.8 million. Pursuant to the agreements, the investors, other than our Chief Executive Officer, Mr. Eytan Bar, paid $3.00 per share for the aggregate 937,500 ordinary shares issued in the private placement. Mr. Bar purchased 14,000 shares at $3.88 per share, the closing price of our ordinary shares on the day prior to the closing of the private placement. The private placement also involved the acquisition by the investors of warrants to purchase an aggregate 375,000 additional ordinary shares at an exercise price of $4.00 per share (subject to anti-dilution adjustments), exercisable from February 10, 2006 until August 10, 2009. Each investor, including Mr. Eytan Bar, received warrants to purchase two ordinary shares for each five ordinary shares purchased. Mr. Lior Salansky, a principal shareholder and our President since February 2008, also participated in the private placement.

Mr. Chaim Mer, a major shareholder and the Chairman of our Board of Directors, devotes approximately 20% of his time to the management of our company in consideration of which we pay him a monthly salary of $7,000 per month (as approved by our Audit Committee and Board of Directors on November 8, 1999). Mr. Isaac Ben-Bassat, a major shareholder and a director, receives an annual fee of approximately $8,400 and a per meeting attendance fee of $300 in connection with his service as a director of our company. See Item. 6B. "Directors and Senior Management - Compensation." Mr. Lior Salansky, a major shareholder and our President, devotes approximately 60% of his time to the management of our company in consideration of which we pay him a monthly salary of approximately $9,900 per month plus social benefits (as approved by our Board of Directors on January 24, 2008).



C. INTERESTS OF EXPERTS AND COUNSEL

Not applicable.

ITEM 8. FINANCIAL INFORMATION

A. CONSOLIDATED STATEMENTS AND OTHER FINANCIAL INFORMATION

FINANCIAL STATEMENTS

See the consolidated financial statements, including the notes thereto, and the exhibits listed in Item 19 hereof and incorporated herein by this reference.

EXPORT SALES

See Note 16 of our consolidated financial statements.

LEGAL PROCEEDINGS

On April 18, 2005, Amdocs (Israel) Ltd. and Amdocs Ltd. filed a complaint in the Tel Aviv District Court naming our company, our chief executive officer

and others as defendants (Civil File No. 32419-05/05). The complaint alleges, among other things, that professional and commercial information belonging to the plaintiffs was transferred to the defendants for use in our company's activity. The plaintiffs are seeking an injunction prohibiting the defendants from making any use of the information and trade secrets that were allegedly transferred, and mandatory injunctions requiring the return of any such information and the payment of estimated damages of NIS 14,775,000 (approximately $3.5 million). On June 27, 2005, we and the other defendants filed a statement of defense, claiming that the factual and legal allegations made by the plaintiffs have no basis and the causes of action and relief requested are without merit. On March 22, 2007, the complaint was dismissed without prejudice by mutual agreement and following a settlement between all parties to the complaint and with no payment by any of the litigants.

In April 2000, the tax authorities in Israel issued to us a demand for a tax payment in the amount of approximately NIS 6.0 million (approximately $1.6 million) for the 1997-1999 period. We have appealed to the Israeli district court in respect of this tax demand. We believe that certain defenses can be raised against the demand of the tax authorities. We have made a provision in our financial statements for this tax demand for the amount deemed probable, based on the current evidence, which we believe is adequate.

On November 22, 2005, we received a letter from one of our customer's legal counsel alleging, among other things, that we materially breached an agreement relating to our billing solutions that we entered into with the customer on March 9, 2005, as subsequently amended on June 6, 2005. The customer is seeking full repayment of the amounts that were paid by him under the agreement in the amount of approximately $100,000, plus interest and indemnification for damages that he claims to have suffered as a result of our alleged breach. We and the customer have since exchanged correspondence. We cannot currently assess the outcome or possible adverse effect on our financial position or results of operations.

On February 21, 2007, one of our suppliers filed a complaint in the Kfar-Saba Magistrate Court against us, under which he seeks the payment of NIS 179,000 (approximately $47,000) for electronic components that were ordered by us for a third party, which is the customer referred to in the foregoing paragraph. On March 13, 2007, we filed a statement of defense. We have made a provision in our financial statements for the claimed amount. Due to the preliminary stage of this litigation, we and our legal advisors cannot currently assess the outcome or possible adverse effect on our financial position or results of operations.



On July 24, 2006, a claim was filed in the Tel-Aviv Magistrate Court against our company and Tim Computers and Systems Ltd, or TIM, for an order of inspection and monetary relief in the total amount of NIS 313,000 ($81,000), of which NIS 113,000 ($29,000) is demanded from our company and NIS 200,000 ($52,000) is demanded from TIM. The plaintiff is a former minority shareholder of a company in which we were the major shareholder. The claim relates to the rights to proceeds received under a software development project in which TIM and our company participated and in which the plaintiff was involved. A preliminary hearing was held on Jan. 15, 2007. Due to the preliminary stage of this litigation, we and our legal advisors cannot currently assess the outcome or possible adverse effect on our financial position or results of operations.

On March 15, 2007, we received a letter from one of our customer's legal counsel alleging, among other things, that we materially breached an agreement

relating to our billing solutions that we entered into with the customer on March 30, 2006. The customer is seeking full repayment of the amounts that were paid by him under the agreement in the amount of approximately $141,000, plus liquidated damages as provided in the agreement. We believe that the agreement cancellation was unfounded and intend to vigorously pursue our rights under the contract. Due to the preliminary stage of this matter, we and our legal advisors cannot currently assess the outcome or possible adverse effect on our financial position or results of operations.

During August 2007, our Brazilian subsidiary, TABS Brazil Ltda., was ordered by the Labor Law Court in Brazil to pay approximately 180,000 Brazilian Reais (approximately $101,000) to one of its former employees. TABS Brazil Ltda. has filed an appeal against the Labor Law Court ruling. We recorded a provision in our financial statements for the amount deemed probable.

Other than the above, we are not involved in any legal proceedings nor are we subject to any threatened litigation that are material to our business or financial condition.

DIVIDEND DISTRIBUTION POLICY

We have never paid cash dividends to our shareholders. We intend to retain future earnings for use in our business and do not anticipate paying cash dividends on our ordinary shares in the foreseeable future. Any future dividend policy will be determined by our Board of Directors and will be based upon conditions then existing, including our results of operations, financial condition, current and anticipated cash needs, contractual restrictions and other conditions as the Board of Directors may deem relevant.

According to the Israeli Companies Law, a company may distribute dividends out of its profits (as such term is defined in the Israeli Companies Law), provided that there is no reasonable concern that payment of the dividend will prevent the company from satisfying all its current and foreseeable obligations, as they become due. Notwithstanding the foregoing, dividends may be paid with the approval of a court, at the company's request, provided that there is no reasonable concern that payment of the dividend will prevent the company from satisfying its current and foreseeable obligations, as they become due. In the event cash dividends are declared, such dividends will be paid in NIS.

B. SIGNIFICANT CHANGES

Except as otherwise disclosed in this annual report, no significant change has occurred since December 31, 2007.

ITEM 9. THE OFFER AND LISTING

A. OFFER AND LISTING DETAILS

ANNUAL STOCK INFORMATION

The following table sets forth, for each of the years indicated, the range of high ask and low bid prices of our ordinary shares on the NASDAQ Capital Market.

| YEAR | HIGH | LOW |
|---|---|---|
| 2007 | $3.26 | $0.02 |
| 2006 | $3.50 | $1.50 |
| 2005 | $4.23 | $3.01 |
| 2004 | $4.00 | $1.90 |
| 2003 | $3.56 | $0.87 |

QUARTERLY STOCK INFORMATION

The following table sets forth, for each of the full financial quarters in the years indicated, the range of high ask and low bid prices of our ordinary shares on the NASDAQ Capital Market.

| | HIGH | LOW |
|---|---|---|
| 2006 | | |
| First Quarter | $3.50 | $2.94 |
| Second Quarter | $3.34 | $2.32 |
| Third Quarter | $2.85 | $2.01 |
| Fourth Quarter | $2.49 | $1.50 |
| 2007 | | |
| First Quarter | $1.92 | $1.53 |
| Second Quarter | $1.65 | $1.35 |
| Third Quarter | $3.26 | $0.75 |
| Fourth Quarter | $1.65 | $0.02 |
| 2008 | | |
| First Quarter | $1.55 | $0.75 |

MONTHLY STOCK INFORMATION

The following table sets forth, for each of the most recent six months, the range of high ask and low bid prices of our ordinary shares on the NASDAQ Capital Market.

| MONTH | HIGH | LOW |
|---|---|---|
| October 2007 | $1.65 | $1.10 |
| November 2007 | $1.65 | $1.10 |
| December 2007 | $1.17 | $0.02 |
| January 2008 | $1.09 | $0.75 |
| February 2008 | $1.14 | $0.90 |
| March 2008 | $1.55 | $1.04 |

B. PLAN OF DISTRIBUTION

Not applicable.

C. MARKETS

Our ordinary shares were listed on the NASDAQ National Market in connection with our initial public offering on May 21, 1997. On December 23, 1998, the listing of our ordinary shares was transferred to the NASDAQ Capital Market (symbol: MTSL).

D. SELLING SHAREHOLDERS

Not applicable.

E. DILUTION

Not applicable.



F. EXPENSE OF THE ISSUE

Not applicable.

ITEM 10. ADDITIONAL INFORMATION

A. SHARE CAPITAL

Not applicable.

B. MEMORANDUM AND ARTICLES OF ASSOCIATION

SET OUT BELOW IS A DESCRIPTION OF CERTAIN PROVISIONS OF OUR ARTICLES OF ASSOCIATION AND OF THE ISRAELI COMPANIES LAW RELATED TO SUCH PROVISIONS. THIS DESCRIPTION IS ONLY A SUMMARY AND DOES NOT PURPORT TO BE COMPLETE AND IS QUALIFIED BY REFERENCE TO THE FULL TEXT OF THE ARTICLES OF ASSOCIATION, WHICH ARE INCORPORATED BY REFERENCE AS EXHIBITS TO THIS ANNUAL REPORT, AND TO ISRAELI LAW.

PURPOSES AND OBJECTS OF THE COMPANY

We are a public company registered under the Israel Companies Law, 1999-5759, or the Israeli Companies Law, as MER Telemanagement Solutions Ltd., registration number 520042904. Our objects and purposes, as provided by our Articles of Association, are to carry on any lawful activity.

On February 1, 2000, the Israeli Companies Law came into effect and superseded most of the provisions of the Israeli Companies Ordinance (New Version), 5743-1983, except for certain provisions which relate to bankruptcy, dissolution and liquidation of companies. Under the Israeli Companies Law, various provisions, some of which are detailed below, overrule the current provisions of our Articles of Association.

THE POWERS OF THE DIRECTORS

Under the provisions of the Israeli Companies Law and our Articles of Association, a director cannot participate in a meeting nor vote on a proposal, arrangement or contract in which he or she is materially interested. In addition, our directors cannot vote compensation to themselves or any members of their body without the approval of our audit committee and our shareholders at a general meeting. See Item 6C. "Directors, Senior Management and Employees - Board Practices - Approval of Related Party Transactions Under Israeli Law."

The authority of our directors to enter into borrowing arrangements on our behalf is not limited, except in the same manner as any other transaction by us.

Under our Articles of Association, retirement of directors from office is not subject to any age limitation and our directors are not required to own shares in our company in order to qualify to serve as directors.

RIGHTS ATTACHED TO SHARES

Our authorized share capital consists of 12,000,000 ordinary shares of a

nominal value of NIS 0.01 each. All outstanding ordinary shares are validly issued, fully paid and non-assessable.

The rights attached to the ordinary shares are as follows:

DIVIDEND RIGHTS. Holders of our ordinary shares are entitled to the full amount of any cash or share dividend subsequently declared. The board of directors may declare interim dividends and propose the final dividend with respect to any fiscal year only out of the retained earnings, in accordance with the provisions of the Israeli Companies Law. Our Articles of Association provide that the declaration of a dividend requires approval by an ordinary resolution of the shareholders, which may decrease but not increase the amount proposed by the board of directors. See Item 8A. "Financial Information - Consolidated and Other Financial Information - Dividend Distribution Policy." If after one year a dividend has been declared and it is still unclaimed, the board of directors is entitled to invest or utilize the unclaimed amount of dividend in any manner to our benefit until it is claimed. We are not obligated to pay interest or linkage differentials on an unclaimed dividend.



VOTING RIGHTS. Holders of ordinary shares have one vote for each ordinary share held on all matters submitted to a vote of shareholders. Such voting rights may be affected by the grant of any special voting rights to the holders of a class of shares with preferential rights that may be authorized in the future.

The quorum required for an ordinary meeting of shareholders consists of at least two shareholders present in person or represented by proxy who hold or represent, in the aggregate, at least one third of the voting rights of the issued share capital. A meeting adjourned for lack of a quorum generally is adjourned to the same day in the following week at the same time and place or any time and place as the directors designate in a notice to the shareholders. At the reconvened meeting, the required quorum consists of any two members present in person or by proxy.

An ordinary resolution, such as a resolution for the declaration of dividends, requires approval by the holders of a majority of the voting rights represented at the meeting, in person, by proxy or by written ballot, and voting thereon. Under our Articles of Association, a special resolution, such as amending our memorandum of association or articles of association, approving any change in capitalization, winding-up, authorization of a class of shares with special rights, or other changes as specified in our Articles of Association, requires approval of a special majority, representing the holders of no less than 65% of the voting rights represented at the meeting in person, by proxy or by written ballot, and voting thereon.

Pursuant to our articles of association, our directors (other than outside directors) are elected at our annual general meeting of shareholders by a vote of the holders of a majority of the voting power represented and voting at such meeting and hold office until the next annual general meeting of shareholders and until their successors have been elected. All the members of our Board of Directors (except the outside directors) may be reelected upon completion of their term of office. For information regarding the election of outside directors, see Item 6C. "Directors, Senior Management and Employees - Board Practices - Election of Directors."

RIGHTS TO SHARE IN OUR COMPANY'S PROFITS. Our shareholders have the right to share in our profits distributed as a dividend and any other permitted

distribution. See this Item 10B. "Additional Information - Memorandum and Articles of Association - Rights Attached to Shares - Dividend Rights."

RIGHTS TO SHARE IN SURPLUS IN THE EVENT OF LIQUIDATION. In the event of our liquidation, after satisfaction of liabilities to creditors, our assets will be distributed to the holders of ordinary shares in proportion to the nominal value of their holdings. This right may be affected by the grant of preferential dividend or distribution rights to the holders of a class of shares with preferential rights that may be authorized in the future.

LIABILITY TO CAPITAL CALLS BY OUR COMPANY. Under our memorandum of association and the Israeli Companies Law, the liability of our shareholders is limited to the par value of the shares held by them.

LIMITATIONS ON ANY EXISTING OR PROSPECTIVE MAJOR SHAREHOLDER. See Item 6C. "Directors and Senior Management -Board Practices - Approval of Related Party Transactions Under Israeli Law."

CHANGING RIGHTS ATTACHED TO SHARES

According to our Articles of Association, in order to change the rights attached to any class of shares, unless otherwise provided by the terms of the class, such change must be adopted by a general meeting of the shareholders and by a separate general meeting of the holders of the affected class with a majority of 75% of the voting power participating in such meeting.



ANNUAL AND EXTRAORDINARY MEETINGS

Under the Israeli Companies Law a company must convene an annual meeting of shareholders at least once every calendar year and within fifteen months of the last annual meeting. Depending on the matter to be voted upon, notice of at least 21 days or 35 days prior to the date of the meeting is required. Our board of directors may, in its discretion, convene additional meetings as "special general meetings." With respect to "special general meetings notice of at least 35 days prior to the date of the meeting is required. In addition, the board must convene a special general meeting upon the demand of two of the directors, 25% of the nominated directors, one or more shareholders having at least 5% of the outstanding share capital and at least 1% of the voting power in the company, or one or more shareholders having at least 5% of the voting power in the company. See Item 10B. "Additional Information - Memorandum and Articles of Association - Rights Attached to Shares - Voting Rights."

LIMITATIONS ON THE RIGHTS TO OWN SECURITIES IN OUR COMPANY

Neither our memorandum of association or our articles of association nor the laws of the State of Israel restrict in any way the ownership or voting of shares by non-residents, except with respect to subjects of countries, which are in a state of war with Israel.

PROVISIONS RESTRICTING CHANGE IN CONTROL OF OUR COMPANY

The Israeli Companies Law requires that mergers between Israeli companies be approved by the board of directors and general meeting of shareholders of both parties to the transaction. The approval of the board of directors of both companies is subject to such boards' confirmation that there is no reasonable doubt that after the merger the surviving company will be able to fulfill its obligations towards its creditors. Each company must notify its creditors about

the contemplated merger. Under our articles of association, such merger must be approved by a resolution of the shareholders, as explained above. The approval of the merger by the general meetings of shareholders of the companies is also subject to additional approval requirements as specified in the Israeli Companies Law and regulations promulgated thereunder. See also Item 6C. "Directors, Senior Management and Employees - Board Practices - Approval of Related Party Transactions Under Israeli Law."

DISCLOSURE OF SHAREHOLDERS OWNERSHIP

The Israeli Securities Law and regulations promulgated thereunder do not require a company whose shares are publicly traded solely on a stock exchange outside of Israel, as in the case of our company, to disclose its share ownership.

CHANGES IN OUR CAPITAL

Changes in our capital are subject to the approval of the shareholders at a general meeting by a special majority of 65% of the votes of shareholders participating and voting in the general meeting.

C. MATERIAL CONTRACTS

On August 10, 2005, we entered into definitive agreements with institutional and private investors, including our Chief Executive Officer, Mr. Eytan Bar, for a private placement of ordinary shares and warrants to purchase ordinary shares that raised $2.8 million. Mr. Lior Salansky, a principal shareholder and our President since February 2008, also participated in the private placement. Pursuant to the agreements, the investors, other than Mr. Bar, paid $3.00 per share for the aggregate 923,500 ordinary shares issued in the private placement. Mr. Bar purchased 14,000 shares at $3.88 per share, the closing price of our ordinary shares on the day prior to the closing of the private placement. The private placement also involved the acquisition by the investors of warrants to purchase an aggregate 375,000 additional ordinary shares at an exercise price of $4.00 per share (subject to anti-dilution adjustments), exercisable from February 10, 2006 until August 10, 2009. Each investor, including Mr. Eytan Bar, received warrants to purchase two ordinary shares for each five ordinary shares purchased. To date, no warrants have been exercised.



On July 31, 2006, we completed the acquisition of certain assets and liabilities of TelSoft, a California-based provider of call accounting and TEM solutions. TelSoft products offer a complementary solution to our products. In connection with the acquisition, we paid an initial consideration of $1.1 million and agreed to pay additional contingent consideration based on post acquisition revenue performance during the 12 month period following the acquisition.

D. EXCHANGE CONTROLS

Israeli law and regulations do not impose any material foreign exchange restrictions on non-Israeli holders of our ordinary shares. In May 1998, a new "general permit" was issued under the Israeli Currency Control Law, 1978, which removed most of the restrictions that previously existed under such law, and enabled Israeli citizens to freely invest outside of Israel and freely convert Israeli currency into non-Israeli currencies.

Non-residents of Israel who purchase our ordinary shares will be able to convert dividends, if any, thereon, and any amounts payable upon our dissolution, liquidation or winding up, as well as the proceeds of any sale in Israel of our ordinary shares to an Israeli resident, into freely repatriable dollars, at the exchange rate prevailing at the time of conversion, provided that the Israeli income tax has been withheld (or paid) with respect to such amounts or an exemption has been obtained.

E. TAXATION

The following is a discussion of Israeli and United States tax consequences material to our shareholders. To the extent that the discussion is based on new tax legislation which has not been subject to judicial or administrative interpretation, the views expressed in the discussion might not be accepted by the tax authorities in question. The discussion is not intended, and should not be construed, as legal or professional tax advice and does not exhaust all possible tax considerations.

HOLDERS OF OUR ORDINARY SHARES SHOULD CONSULT THEIR OWN TAX ADVISORS AS TO THE UNITED STATES, ISRAELI OR OTHER TAX CONSEQUENCES OF THE PURCHASE, OWNERSHIP AND DISPOSITION OF ORDINARY SHARES, INCLUDING, IN PARTICULAR, THE EFFECT OF ANY FOREIGN, STATE OR LOCAL TAXES.

ISRAELI TAX CONSIDERATIONS

The following is a summary of the current tax structure applicable to companies in Israel, with special reference to its effect on us. The following also contains a discussion of the material Israeli tax consequences to purchasers of our ordinary shares and Israeli government programs benefiting us. This summary does not discuss all the aspects of Israeli tax law that may be relevant to a particular investor in light of his or her personal investment circumstances or to some types of investors subject to special treatment under Israeli law.

GENERAL CORPORATE TAX STRUCTURE

Israeli companies are generally subject to income tax on their taxable income. The applicable rate for 2007 is 29%, which was reduced to 27% in 2008 and will be further reduced to 26% in 2009 and 25% in 2010 and thereafter. However, the effective tax rate payable by a company, which derives income from an approved enterprise (as further discussed below), may be considerably less.

CONTROLLED FOREIGN COMPANIES

Under the controlled foreign companies rules an Israeli company may become subject to Israeli taxes (as deemed dividends) on non-distributed profits of a non-Israeli subsidiary if the subsidiary's primary source of income is passive income (such as interest, dividends, royalties, rental income or capital gains) and if the taxes imposed outside of Israel are no more than 20% of the profits.



TAX BENEFITS UNDER THE LAW FOR THE ENCOURAGEMENT OF CAPITAL INVESTMENTS, 1959

The Law for the Encouragement of Capital Investments, 1959, commonly referred to as the Investment Law, provides that a proposed capital investment in eligible facilities may, upon application to the Investment Center of the Ministry of Industry, Trade and Labor of the State of Israel, be designated as an approved enterprise. Each certificate of approval for an approved enterprise

relates to a specific investment program delineated both by its financial scope, including its capital sources, and by its physical characteristics, E.G., the equipment to be purchased and utilized pursuant to the program. An approved enterprise is entitled to benefits including Israeli Government cash grants and tax benefits in specified development areas. The tax benefits derived from any such certificate of approval relate only to taxable income attributable to the specific approved enterprise. If a company has more than one approval or only a portion of its capital investments is approved, its effective tax rate is the result of a weighted average of the applicable rates.

Taxable income of a company derived from an approved enterprise is subject to corporate tax at the maximum rate of 25% (rather than the regular corporate tax rate) for the benefit period. This period is ordinarily seven years (or ten years if the company qualifies as a foreign investors' company as described below) commencing with the year in which the approved enterprise first generates taxable income, and is limited to twelve years from commencement of production or 14 years from the date of approval, whichever is earlier. Tax benefits under the Investments Law also apply to income generated from the grant of a usage right with respect to know-how developed by the approved enterprise, income generated from royalties, and income derived from a service which is auxiliary to such usage right or royalties, provided that such income is generated within the approved enterprise's ordinary course of business. The Investment Law also provides that a company that has an approved enterprise within Israel will be eligible for a reduced tax rate and is entitled to claim accelerated depreciation on buildings, machinery and equipment used by the approved enterprise during the first five years of use.

A company owning an approved enterprise may elect to forego entitlement to the grants otherwise available under the Investment Law and in lieu thereof participate in an alternative track of benefits. Under the alternative track of benefits, a company's undistributed income derived from an approved enterprise will be exempt from company tax for a period of two years from the first year of taxable income and such company will be eligible for a reduced tax rate for the remainder, if any, of the otherwise applicable benefits period.

A company that has an approved enterprise program is eligible for further tax benefits if it qualifies as a foreign investors' company. A foreign investors' company is a company that more than 25% of its share capital and combined share and loan capital is owned by non-Israeli residents. A company, which qualifies as a foreign investors' company and has an approved enterprise program is eligible for tax benefits for a ten-year benefit period. The company tax rate applicable to income from the approved enterprise earned in the benefit period (distributed or not) is as follows:

| FOR A COMPANY WITH FOREIGN INVESTMENT OF | THE COMPANY TAX RATE IS |
|---|---|
| over 25% but less than 49% | 25% |
| 49% or more but less than 74% | 20% |
| 74% or more but less than 90% | 15% |
| 90% or more | 10% |

In addition, the dividend recipient is taxed at the reduced rate applicable to dividends from approved enterprises income (15%), if the dividend, deriving from the approved enterprises, is distributed during the tax benefit period or within 12 years thereafter, yet, no time limit is applicable to dividends from a foreign investment company. The company must withhold this tax at source, regardless of whether the dividend is converted into foreign currency. However, if retained tax-exempt income is distributed in a manner other than upon the complete liquidation of the company, the company would be taxed at the reduced corporate tax rate applicable to such profits (between 10%-25%). Our company is

not obliged to distribute exempt retained profits under the alternative track of benefits, and may generally decide from which source of income to declare dividends. We intend to reinvest any income derived from our approved enterprise programs and not to distribute such income as a dividend.



We have been granted approved enterprise status with respect to several investment programs and chose the alternative track with respect to each of these programs. See Item 5A. "Operating and Financial Review and Prospects - Operating Results - Effective Corporate Tax Rate."

The benefits available to an approved enterprise are conditional upon the fulfillment of conditions stipulated in the Investment Law and its regulations and the criteria set forth in the specific certificate of approval, as described above. In the event that a company does not meet these conditions, its tax benefits could be canceled, in whole or in part, and it would be required to refund the amount of tax benefits, with the addition of the Israeli consumer price index linkage adjustment and interest.

AMENDMENT TO THE INVESTMENTS LAW

An amendment to the Investments Law, which came into effect on April 1, 2005, has changed certain provisions of such law, including the criteria for investments qualified to receive tax benefits under such law. An eligible investment program under the amendment will qualify for benefits as a "Privileged Enterprise" (rather than the previous terminology of Approved Enterprise). As a result of the amendment, a company is no longer obliged to acquire approved enterprise status in order to receive the tax benefits previously available under the alternative benefits track, and therefore there is no need to apply to the Investment Center for this purpose (however, approved enterprise status remains mandatory for companies seeking grants). Rather, a company may claim the tax benefits offered by the Investment Law directly in its tax returns, provided that its facilities meet the criteria for tax benefits set out by the amendment. Companies may also approach the Israeli Tax Authority for a pre-ruling regarding its eligibility for benefits under the amendment. The amendment does not apply to investment programs approved prior to December 31, 2004. The new tax regime will apply only to new investment programs.

Tax benefits are available under the April 2005 amendment to production facilities (or other eligible facilities), which are generally required to derive more than 25% of their business income from export. In order to receive the tax benefits, a company must make an investment in the Privileged Enterprise exceeding a minimum amount specified in the Investment Law. Such investment may be made over a period of no more than three years ending at the end of the year in which the company requested to have the tax benefits apply to the Privileged Enterprise, referred to as the Year of Election. Where the company requests to have the tax benefits apply to an expansion of existing facilities, only the expansion will be considered a Privileged Enterprise and the company's effective tax rate will be the result of a weighted combination of the applicable rates. In such case, the minimum investment required in order to qualify as a Privileged Enterprise is required to exceed a certain percentage of the company's production assets before the expansion.

TAX BENEFITS FOR RESEARCH AND DEVELOPMENT

Israeli tax law allows, under specified conditions, a tax deduction for expenditures, including capital expenditures, in the year incurred relating to scientific research and development projects, if the expenditures are approved

by the relevant Israeli Government ministry, determined by the field of research, and the research and development is for the promotion of the company and is carried out by or on behalf of the company seeking such deduction. However, the amount of such deductible expenses shall be reduced by the sum of any funds received through government grants for the finance of such scientific research and development projects. Expenditures not so approved are deductible over a three-year period.



TAX BENEFITS UNDER THE LAW FOR THE ENCOURAGEMENT OF INDUSTRY (TAXES), 1969

Under the Law for the Encouragement of Industry (Taxes), 1969, or the Industry Encouragement Law, Industrial Companies are entitled to certain corporate tax benefits, including, among others:

- deduction, under certain conditions, of purchases of know-how and patents over an eight-year period for tax purposes;
- right to elect, under specified conditions, to file a consolidated tax return with additional related Israeli Industrial Companies;
- accelerated depreciation rates on equipment and buildings; and
- deductions over a three-year period of expenses involved with the issuance and listing of shares on the Tel Aviv Stock Exchange or, on or after January 1, 2003, on a recognized stock market outside of Israel.

Eligibility for benefits under the Industry Encouragement Law is not subject to receipt of prior approval from any governmental authority. Under the Industry Encouragement Law, an "Industrial Company" is defined as a company resident in Israel, at least 90% of the income of which, in any tax year, determined in Israeli currency, exclusive of income from government loans, capital gains, interest and dividends, is derived from an "Industrial Enterprise" owned by it. An "Industrial Enterprise" is defined as an enterprise owned by an Industrial Company, whose major activity in a given tax year is industrial production activity.

We believe that we currently qualify as an Industrial Company within the definition of the Industry Encouragement Law. No assurance can be given that we will continue to qualify as an Industrial Company or that the benefits described above will be available in the future.

GRANTS UNDER THE LAW FOR THE ENCOURAGEMENT OF INDUSTRIAL RESEARCH AND DEVELOPMENT, 1984

The Government of Israel encourages research and development projects through the Office of Chief Scientist of the Israeli Ministry of Industry, Trade and Labor, or the Office of the Chief Scientist, pursuant to the Law for the Encouragement of Industrial Research and Development, 1984, and the regulations promulgated thereunder, commonly referred to as the Research Law. Grants received under such programs are repaid through a mandatory royalty based on revenues from products incorporating know-how developed with the grants. This government support is conditioned upon the ability of the participant to comply with certain applicable requirements and conditions specified in the Office of the Chief Scientist's programs and with the provisions of the Research Law.

Under the Research Law, research and development programs which meet

specified criteria and are approved by a research committee of the Office of the Chief Scientist are eligible for grants of up to 50% of certain of the project's approved expenditure, as determined by the research committee.

In exchange, the recipient of such grants is required to pay the Office of the Chief Scientist royalties from the revenues derived from products incorporating technology developed within the framework of the approved research and development program or derived from such program (including ancillary services in connection with such program), usually up to100% of the U.S. dollar-linked value of the total grants received in respect of such program, plus LIBOR interest.

The terms of the Israeli Government participation generally requires that the products developed with such grants be manufactured in Israel. However, under regulations promulgated under the Research Law, upon the approval of the Chief Scientist, some of the manufacturing volume may be performed outside Israel, provided that the grant recipient pays royalties at an increased rate. The Research Law also allows for the approval of grants in cases in which the applicant declares that part or all of the manufacturing will be performed outside of Israel or by non-Israeli residents and the research committee is convinced that this is essential for the execution of the program. The Research Law also provides that know-how developed under an approved research and development program may not be transferred to third parties in Israel without the prior approval of the research committee. The Research Law further provides that the know-how developed under an approved research and development program may not be transferred to any third parties outside Israel. No approval is required for the sale or export of any products resulting from such research and development.



However, in June 2005, an amendment to the Research Law became effective, which amendment was intended to make the Research Law more compatible with the global business environment by, among other things, relaxing restrictions on the transfer of manufacturing rights outside Israel and on the transfer of Office of the Chief Scientist-funded know-how outside of Israel. The amendment permits the Office of the Chief Scientist, among other things, to approve the transfer of manufacturing rights outside Israel in exchange for an import of different manufacturing into Israel as a substitute, in lieu of demanding the recipient to pay increased royalties as described above. The amendment further permits, under certain circumstances and subject to the Office of the Chief Scientist's prior approval, the transfer outside Israel of know-how that has been funded by Office of the Chief Scientist, generally in the following cases: (a) the grant recipient pays to the Office of the Chief Scientist a portion of the consideration paid for such funded know-how (according to certain formulas), (b) the grant recipient receives know-how from a third party in exchange for its funded know-how, or (c) such transfer of funded know-how arises in connection with certain types of cooperation in research and development activities.

The Research Law imposes reporting requirements with respect to certain changes in the ownership of a grant recipient. The law requires the grant recipient and its controlling shareholders and interested parties to notify the Office of the Chief Scientist of any change in control of the recipient or a change in the holdings of the means of control of the recipient that results in a non-Israeli becoming an interested party directly in the recipient and requires the new interested party to undertake to the Office of the Chief Scientist to comply with the Research Law. In addition, the rules of the Office of the Chief Scientist may require prior approval of the Office of the Chief Scientist or additional information or representations in respect of certain of

such events. For this purpose, "control" is defined as the ability to direct the activities of a company other than any ability arising solely from serving as an officer or director of the company. A person is presumed to have control if such person holds 50% or more of the means of control of a company. "Means of control" refers to voting rights or the right to appoint directors or the chief executive officer. An "interested party" of a company includes a holder of 5% or more of its outstanding share capital or voting rights, its chief executive officer and directors, someone who has the right to appoint its chief executive officer or at least one director, and a company with respect to which any of the foregoing interested parties owns 25% or more of the outstanding share capital or voting rights or has the right to appoint 25% or more of the directors. Accordingly, any non-Israeli who acquires 1% or more of our ordinary shares will be required to notify the Office of the Chief Scientist that it has become an interested party and to sign an undertaking to comply with the Research Law. Additionally, procedures regulated under the Research Law require the grant recipient to obtain the approval of the Office of the Chief Scientist prior to a change in the holdings of the recipient or change in the holdings of the means of control of the recipient if the recipient's shares are being issued to a non-Israeli person or entity and require the new non-Israeli party to undertake to the Office of the Chief Scientist to comply with the Research Law.

In the past, we received funding from the Office of the Chief Scientist for selected research and development projects, but we stopped seeking funding for a number of years. In 2005, 2006 and 2007, we received the approval of the Office of the Chief Scientist for new research and development grants in the aggregate amount of $130,000, $578,000 and $469,000, respectively. See Item 5C. "Operating and Financial Review and Prospects - Research and Development, Patents and Licenses" for additional details on the grants that we have received and our contingent liability to the Office of the Chief Scientist.

SPECIAL PROVISIONS RELATING TO TAXATION UNDER INFLATIONARY

The Income Tax Law (Inflationary Adjustments), 1985, generally referred to as the Inflationary Adjustments Law, represents an attempt to overcome the problems presented to a traditional tax system by an economy undergoing rapid inflation. The Inflationary Adjustments Law is highly complex. Its features, which are material to us, can be summarized as follows:

- There is a special tax adjustment for the preservation of equity whereby some corporate assets are classified broadly into fixed assets and non-fixed assets. Where a company's equity, as defined in such law, exceeds the depreciated cost of fixed assets, a deduction from taxable income that takes into account the effect of the applicable annual rate of inflation on such excess is allowed up to a ceiling of 70% of taxable income in any single tax year, with the unused portion permitted to be carried forward on a linked basis. If the depreciated cost of fixed assets exceeds a company's equity, then such excess multiplied by the applicable annual rate of inflation is added to taxable income.



- Subject to specific limitations, depreciation deductions on fixed assets and losses carried forward are adjusted for inflation based on the increase in the consumer price index.

On February 26, 2008, the Israeli Parliament (the Knesset) enacted the Income Tax Law (Inflationary Adjustments) (Amendment No. 20) (Restriction of Effective Period), 2008, which we refer to as the Inflationary Adjustments

Amendment. In accordance with the Inflationary Adjustments Amendment, the effective period of the Inflationary Adjustments Law will cease at the end of the 2007 tax year and as of the 2008 tax year the provisions of the law shall no longer apply, other than the transitional provisions intended at preventing distortions in the tax calculations. In accordance with the Inflationary Adjustments Amendment, commencing the 2008 tax year, income for tax purposes will no longer be adjusted to a real (net of inflation) measurement basis. Furthermore, the depreciation of inflation immune assets and carried forward tax losses will no longer be linked to the Israeli consumer price index.

TAXATION OF NON-ISRAELI SHAREHOLDERS ON RECEIPT OF DIVIDENDS

Under Israeli tax law, a distribution of dividends from income attributable to an Approved Enterprise and Privileged Enterprise will be subject to tax in Israel at the rate of 15%, which is withheld and paid by the company paying the dividend, if the dividend is distributed during the benefits period or within the following 12 years (but the 12-year limitation does not apply to a Foreign Investors Company). Any distribution of dividends from income that is not attributable to an Approved Enterprise will be subject to tax in Israel at the rate of 25%, except that dividends distributed on or after January 1, 2006 to an individual and an entity who is deemed "a non-substantial shareholder" will be subject to tax at the rate of 20%.

Under the U.S.-Israel tax treaty, the maximum tax on dividends paid to a holder of ordinary shares who is a U.S. resident is 25%. Dividends received by a U.S. company that holds at least 10% of our voting rights will be subject to withholding tax at the rate of 12.5%, provided certain other conditions in the tax treaty are met (or at the tax rate of 15% in respect of dividends paid from income attributable to our Approved Enterprises and Privileged Enterprises).

CAPITAL GAINS TAXES APPLICABLE TO NON-ISRAELI SHAREHOLDERS

Capital gains from the sale of our ordinary shares by non-Israeli shareholders are exempt from Israeli taxation, provided that the capital gain is not derived from a permanent establishment in Israel. However, non-Israeli corporations will not be entitled to such exemption, if an Israeli resident (i) has a controlling interest of 25% or more in such non-Israeli corporation, or (ii) is the beneficiary or is entitled to 25% or more of the revenues or profits of such non-Israeli corporation, whether directly or indirectly. In the event that an exemption is not available, taxation of the non-Israeli resident may be subject to the provisions of a tax treaty, if such treaty exists between Israel and the applicable country. In some instances where our shareholders may be subject to Israeli tax on the sale of their ordinary shares, the payment of the consideration may be subject to the withholding of Israeli tax at the source.

In addition, the United States-Israel tax treaty exempts U.S. residents who hold less than 10% of our voting rights, and who held less than 10% of our voting rights during the 12 months prior to a sale of their shares, from Israeli capital gains tax in connection with such sale.



FOREIGN EXCHANGE REGULATIONS

Dividends (if any) paid to the holders of our ordinary shares, and any amounts payable with respect to our ordinary shares upon dissolution, liquidation or winding up, as well as the proceeds of any sale in Israel of the ordinary shares to an Israeli resident, may be paid in non-Israeli currency or, if paid in Israeli currency, may be converted into freely reparable U.S. dollars

at the rate of exchange prevailing at the time of conversion, however, Israeli income tax is required to have been paid or withheld on these amounts.

UNITED STATES FEDERAL INCOME TAX CONSEQUENCES

The following is a summary of certain material U.S. federal income tax consequences that apply to U.S. Holders who hold ordinary shares as capital assets. This summary is based on the United States Internal Revenue Code of 1986, as amended, or the Code, Treasury regulations promulgated thereunder, judicial and administrative interpretations thereof, and the U.S.-Israel Tax Treaty, all as in effect on the date hereof and all of which are subject to change either prospectively or retroactively. This summary does not address all tax considerations that may be relevant with respect to an investment in ordinary shares. This summary does not account for the specific circumstances of any particular investor, such as:

- broker-dealers,
- financial institutions,
- certain insurance companies,
- regulated investment companies,
- investors liable for alternative minimum tax,
- tax-exempt organizations,
- non-resident aliens of the U.S. or taxpayers whose functional currency is not the U.S. dollar,
- persons who hold the ordinary shares through partnerships or other pass-through entities,
- persons who acquired their ordinary shares through the exercise or cancellation of employee stock options or otherwise as compensation for services,
- certain expatriates or former long-term residents of the United States,
- investors that own or have owned, directly, indirectly or by attribution, 10 percent or more of our voting shares, and
- investors holding ordinary shares as part of a straddle or appreciated financial position or a hedging or conversion transaction.

If a partnership or an entity treated as a partnership for U.S. federal income tax purposes owns ordinary shares, the U.S. federal income tax treatment of a partner in such a partnership will generally depend upon the status of the partner and the activities of the partnership. A partnership that owns ordinary shares and the partners in such partnership should consult their tax advisors about the U.S. federal income tax consequences of holding and disposing of ordinary shares.



This summary does not address the effect of any U.S. federal taxation other than U.S. federal income taxation. In addition, this summary does not include

any discussion of state, local or foreign taxation.

You are urged to consult your tax advisors regarding the foreign and United States federal, state and local tax considerations of an investment in ordinary shares.

For purposes of this summary, a U.S. Holder is any beneficial owner of ordinary shares that is:

- an individual who is a citizen or, for U.S. federal income tax purposes, a resident of the United States;
- a corporation or other entity created or organized in or under the laws of the United States or any political subdivision thereof;
- an estate whose income is subject to U.S. federal income tax regardless of its source; or
- a trust that (a) is subject to the primary supervision of a court within the United States and the control of one or more U.S. persons or (b) has a valid election in effect under applicable U.S. Treasury regulations to be treated as a U.S. person.

TAXATION OF DIVIDENDS

SUBJECT TO THE DISCUSSION BELOW UNDER THE HEADING "PASSIVE FOREIGN INVESTMENT COMPANIES," the gross amount of any distributions received with respect to ordinary shares, including the amount of any Israeli taxes withheld therefrom, will constitute dividends for U.S. federal income tax purposes, to the extent of our current and accumulated earnings and profits as determined for U.S. federal income tax purposes. You will be required to include this amount of dividends in gross income as ordinary income. Distributions in excess of our earnings and profits will be treated as a non-taxable return of capital to the extent of your tax basis in the ordinary shares, and any amount in excess of your tax basis will be treated as gain from the sale of ordinary shares. See "--Disposition of Ordinary Shares" below for the discussion on the taxation of capital gains. Dividends will not qualify for the dividends-received deduction generally available to corporations under Section 243 of the Code.

Dividends that we pay in NIS, including the amount of any Israeli taxes withheld therefrom, will be included in your income in a U.S. dollar amount calculated by reference to the exchange rate in effect on the day such dividends are received. A U.S. Holder who receives payment in NIS and converts NIS into U.S. dollars at an exchange rate other than the rate in effect on the day of receipt may have a foreign currency exchange gain or loss that would be treated as ordinary income or loss. U.S. Holders should consult their own tax advisors concerning the U.S. tax consequences of acquiring, holding and disposing of NIS.

Subject to complex limitations, any Israeli withholding tax imposed on such dividends will be a foreign income tax eligible for credit against a U.S. Holder's U.S. federal income tax liability, subject to certain limitations set out in the Code (or, alternatively, for deduction against income in determining such tax liability). The limitations set out in the Code include computational rules under which foreign tax credits allowable with respect to specific classes of income cannot exceed the U.S. federal income taxes otherwise payable with respect to each such class of income. Dividends generally will be treated as foreign-source passive category income or general category income for United States foreign tax credit purposes. A U.S. Holder will be denied a foreign tax credit with respect to Israeli income tax withheld from dividends received on the ordinary shares to the extent such U.S. Holder has not held the ordinary shares for at least 16 days of the 31-day period beginning on the date which is 15 days before the ex-dividend date or to the extent such U.S. Holder is under

an obligation to make related payments with respect to substantially similar or related property. Any days during which a U.S. Holder has substantially diminished its risk of loss on the ordinary shares are not counted toward meeting the 16-day holding period required by the statute. Further, there are special rules for computing the foreign tax credit limitation of a taxpayer who receives dividends subject to a reduced tax rate. The rules relating to the determination of the foreign tax credit are complex, and you should consult with your personal tax advisors to determine whether and to what extent you would be entitled to this credit.



Subject to certain limitations, "qualified dividend income" received by a noncorporate U.S. Holder through 2010 will be subject to tax at a reduced maximum tax rate of 15 percent. The rate reduction does not apply to dividends received from passive foreign investment companies, see discussion below. Distributions taxable as dividends paid on the ordinary shares should qualify for the 15 percent rate provided that either: (i) we are entitled to benefits under the income tax treaty between the United States and Israel (the "Treaty") or (ii) the ordinary shares are readily tradable on an established securities market in the United States and certain other requirements are met. We believe that we are entitled to benefits under the Treaty and that the ordinary shares currently are readily tradable on an established securities market in the United States. However, no assurance can be given that the ordinary shares will remain readily tradable. The rate reduction does not apply unless certain holding period requirements are satisfied. With respect to the ordinary shares, the U.S. Holder must have held such shares for at least 61 days during the 121-day period beginning 60 days before the ex-dividend date. The rate reduction also does not apply in respect of certain hedged positions or in certain other situations. The legislation enacting the reduced tax rate contains special rules for computing the foreign tax credit limitation of a taxpayer who receives dividends subject to the reduced tax rate. U.S. Holders of ordinary shares should consult their own tax advisors regarding the effect of these rules in their particular circumstances.

DISPOSITION OF ORDINARY SHARES

If you sell or otherwise dispose of ordinary shares, you will recognize gain or loss for U.S. federal income tax purposes in an amount equal to the difference between the amounts realized on the sale or other disposition and the adjusted tax basis in ordinary shares. SUBJECT TO THE DISCUSSION BELOW UNDER THE HEADING "PASSIVE FOREIGN INVESTMENT COMPANIES," such gain or loss generally will be capital gain or loss and will be long-term capital gain or loss if you have held the ordinary shares for more than one year at the time of the sale or other disposition. In general, any gain that you recognize on the sale or other disposition of ordinary shares will be U.S.-source for purposes of the foreign tax credit limitation; losses will generally be allocated against U.S. source income. Deduction of capital losses is subject to certain limitations under the Code.

In the case of a cash basis U.S. Holder who receives NIS in connection with the sale or disposition of ordinary shares, the amount realized will be based on the U.S. dollar value of the NIS received with respect to the ordinary shares as determined on the settlement date of such exchange. A U.S. Holder who receives payment in NIS and converts NIS into United States dollars at a conversion rate other than the rate in effect on the settlement date may have a foreign currency exchange gain or loss that would be treated as ordinary income or loss.

An accrual basis U.S. Holder may elect the same treatment required of cash

basis taxpayers with respect to a sale or disposition of ordinary shares, provided that the election is applied consistently from year to year. Such election may not be changed without the consent of the Internal Revenue Service. In the event that an accrual basis U.S. Holder does not elect to be treated as a cash basis taxpayer (pursuant to the Treasury regulations applicable to foreign currency transactions), such U.S. Holder may have a foreign currency gain or loss for U.S. federal income tax purposes because of differences between the U.S. dollar value of the currency received prevailing on the trade date and the settlement date. Any such currency gain or loss would be treated as ordinary income or loss and would be in addition to gain or loss, if any, recognized by such U.S. Holder on the sale or disposition of such ordinary shares.



PASSIVE FOREIGN INVESTMENT COMPANIES

There is a substantial risk that we may become a passive foreign investment company, or PFIC, for U.S. federal income tax purposes. Our treatment as a PFIC could result in a reduction in the after-tax return to the U.S. Holders of our ordinary shares and may cause a reduction in the value of such shares.

For U.S. federal income tax purposes, we will be classified as a PFIC for any taxable year in which either (i) 75% or more of our gross income is passive income, or (ii) at least 50% of the average value of all of our assets for the taxable year produce or are held for the production of passive income. For this purpose, cash is considered to be an asset which produces passive income. Passive income generally includes dividends, interest, royalties, rents, annuities and the excess of gains over losses from the disposition of assets which produce passive income. As a result of our relatively substantial cash position at the time, we believe that we were a PFIC in certain periods in the past under a literal application of the asset test described above, which looks solely to the market value of our assets. We do not believe that we were a PFIC in 2007.

If we are a PFIC, dividends will not qualify for the reduced maximum tax rate, applicable to qualified dividend income, discussed above, and, unless you timely elect to "mark-to-market" your ordinary shares, as described below:

- you will be required to allocate income recognized upon receiving certain dividends or gain recognized upon the disposition of ordinary shares ratably over the holding period for such ordinary shares,
- the amount allocated to each year during which we are considered a PFIC other than the year of the dividend payment or disposition would be subject to tax at the highest individual or corporate tax rate, as the case may be, in effect for that year and an interest charge would be imposed with respect to the resulting tax liability allocated to each such year,
- the amount allocated to the current taxable year and any taxable year before we became a PFIC would be taxable as ordinary income in the current year, and
- you will be required to make an annual return on IRS Form 8621 regarding distributions received with respect to ordinary shares and any gain realized on your ordinary shares.

In addition, holders of stock in a PFIC may not receive a "step-up" in basis on shares acquired from a decedent.

The PFIC provisions discussed above apply to U.S. persons who directly or indirectly hold stock in a PFIC. Generally, a U.S. person is considered an indirect shareholder of a PFIC if it is:

- A direct or indirect owner of a pass-through entity, including a trust or estate, that is a direct or indirect shareholder of a PFIC,
- A shareholder of a PFIC that is a shareholder of another PFIC, or
- A 50%-or-more shareholder of a foreign corporation that is not a PFIC and that directly or indirectly owns stock of a PFIC.



An indirect shareholder may be taxed on a distribution paid to the direct owner of the PFIC and on a disposition of the stock indirectly owned. Indirect shareholders are strongly urged to consult their tax advisors regarding the application of these rules.

If we become a PFIC and cease to be a PFIC in a future year, a U.S. Holder may avoid the continued application of the tax treatment described above by electing to be treated as if it sold its ordinary shares on the last day of the last taxable year in which we were a PFIC. Any gain would be recognized and subject to tax under the rules described above. Loss would not be recognized. A U.S. Holder's basis in its ordinary shares would be increased by the amount of gain, if any, recognized on the sale. A U.S. Holder would be required to treat its holding period for its ordinary shares as beginning on the day following the last day of the last taxable year in which we were a PFIC.

If the ordinary shares are considered "marketable stock" and if you elect to "mark-to-market" your ordinary shares, you would not be subject to the rules described above. Instead, you will generally include in income any excess of the fair market value of the ordinary shares at the close of each tax year over your adjusted basis in the ordinary shares. If the fair market value of the ordinary shares had depreciated below your adjusted basis at the close of the tax year, you may generally deduct the excess of the adjusted basis of the ordinary shares over its fair market value at that time. However, such deductions generally would be limited to the net mark-to-market gains, if any, that you included in income with respect to such ordinary shares in prior years. Income recognized and deductions allowed under the mark-to-market provisions, as well as any gain or loss (to the extent of net mark-to-market gains) on the disposition of ordinary shares with respect to which the mark-to-market election is made, is treated as ordinary income or loss. Loss on a disposition, to the extent in excess of net mark-to-market gains, would be treated as capital loss. Gain or loss from the disposition of ordinary shares (as to which a "mark-to-market" election was made) in a year in which we are no longer a PFIC will be capital gain or loss. Loss on a disposition, to the extent in excess of net mark-to-market gains, would be treated as capital loss. Our ordinary shares should be considered "marketable stock" if they traded at least 15 days during each calendar quarter of the relevant calendar year in more than de minimis quantities.

A U.S. Holder of ordinary shares will not be able to avoid the tax consequences described above by electing to treat us as a qualified electing fund, or QEF, because we do not intend to prepare the information that U.S. Holders would need to make a QEF election.

BACKUP WITHHOLDING AND INFORMATION REPORTING

Payments in respect of ordinary shares may be subject to information reporting to the U.S. Internal Revenue Service and to U.S. backup withholding tax at a rate equal to the fourth lowest income tax rate applicable to individuals which, under current law, is 28%. Backup withholding will not apply, however, if you (i) are a corporation or come within certain exempt categories, and demonstrate the fact when so required, or (ii) furnish a correct taxpayer identification number and make any other required certification.

Backup withholding is not an additional tax. Amounts withheld under the backup withholding rules may be credited against a U.S. Holder's U.S. tax liability, and a U.S. Holder may obtain a refund of any excess amounts withheld under the backup withholding rules by filing the appropriate claim for refund with the IRS.

Any U.S. Holder who holds 10% or more in vote or value of our ordinary shares will be subject to certain additional United States information reporting requirements.

U.S. GIFT AND ESTATE TAX

An individual U.S. Holder of ordinary shares will be subject to U.S. gift and estate taxes with respect to ordinary shares in the same manner and to the same extent as with respect to other types of personal property.



F. DIVIDEND AND PAYING AGENTS

Not applicable.

G. STATEMENT BY EXPERTS

Not applicable.

H. DOCUMENTS ON DISPLAY

We are subject to the reporting requirements of the United States Securities Exchange Act of 1934, as amended, as applicable to "foreign private issuers" as defined in Rule 3b-4 under the Exchange Act, and in accordance therewith, we file annual and interim reports and other information with the Securities and Exchange Commission.

As a foreign private issuer, we are exempt from certain provisions of the Exchange Act. Accordingly, our proxy solicitations are not subject to the disclosure and procedural requirements of Regulation 14A under the Exchange Act, transactions in our equity securities by our officers and directors are exempt from reporting and the "short-swing" profit recovery provisions contained in Section 16 of the Exchange Act. In addition, we are not required under the Exchange Act to file periodic reports and financial statements as frequently or as promptly as U.S. companies whose securities are registered under the Exchange Act. However, we distribute annually to our shareholders an annual report containing financial statements that have been examined and reported on, with an opinion expressed by, an independent public accounting firm, and we file reports with the Securities and Exchange Commission on Form 6-K containing unaudited financial information for the first three quarters of each fiscal year.

This annual report and the exhibits thereto and any other document we file pursuant to the Exchange Act may be inspected without charge and copied at

prescribed rates at the following Securities and Exchange Commission public reference rooms: 100 F Street, N.E., Room 1580, Washington, D.C. 20549; and on the Securities and Exchange Commission Internet site (http://www.sec.gov) and on our website www.mtsint.com. You may obtain information on the operation of the Securities and Exchange Commission's public reference room in Washington, D.C. by calling the Securities and Exchange Commission at 1-800-SEC-0330 or by visiting the Securities and Exchange Commission's website at http://www.sec.gov, and may obtain copies of our filings from the public reference room by calling 1-800-SEC-0330. The Exchange Act file number for our Securities and Exchange Commission filings is 0-28950.

The documents concerning our company referred to in this annual report may also be inspected at our offices located at 22 Zarhin Street, Ra'anana 43662, Israel.

I. SUBSIDIARY INFORMATION

Not applicable.

ITEM 11. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISKS

EXPOSURE TO MARKET RISKS

We are exposed to a variety of risks, including changes in interest rates affecting primarily the interest received on short-term deposits, and foreign currency fluctuations. We do not use derivative financial instruments to hedge against such exposure.

INTEREST RATE RISK

Our exposure to market risk for changes in interest rates relates primarily to our long term loan. Our long term loan is held in dollars and bears annual interest of the London Inter Bank Offered Rate (LIBOR) + 2%. For purposes of specific risk analysis, we use sensitivity analysis to determine the impact that market risk exposure may have on the financial income derived from our long term loan. The potential annual increase in expenses that would result from a hypothetical change of 10% in the LIBOR rate would be approximately $30,000.



FOREIGN CURRENCY EXCHANGE RISK

We have operations in several countries in connection with the sale of our products. A substantial portion of our sales and expenditures are denominated in dollars. We have mitigated, and expect to continue to mitigate, a portion of our foreign currency exposure through salaries, marketing and support operations in which all costs are local currency based. As a result, our results of operations and cash flows can be affected by fluctuations in foreign currency exchange rates (primarily the Euro and NIS). A hypothetical 10% movement in foreign currency rates (primarily the Euro and NIS) against the dollar, with all other variables held constant on the expected sales, would result in a decrease or increase in expected 2008 sales revenues of approximately $380,000.

ITEM 12. DESCRIPTION OF SECURITIES OTHER THAN EQUITY SECURITIES

Not applicable.

PART II

ITEM 13. DEFAULTS, DIVIDEND ARREARAGES AND DELINQUENCIES

None.

ITEM 14. MATERIAL MODIFICATIONS TO THE RIGHTS OF SECURITY HOLDERS AND USE OF PROCEEDS

Not applicable.

ITEM 15. CONTROLS AND PROCEDURES

Not applicable.

ITEM 15T. CONTROLS AND PROCEDURES

DISCLOSURE CONTROLS AND PROCEDURES

We maintain disclosure controls and procedures that are designed to ensure that information required to be disclosed in its Exchange Act reports is recorded, processed, summarized and reported within the time periods specified in the Securities and Exchange Commission's rules and forms, and that such information is accumulated and communicated to our chief executive officer and chief financial officer to allow timely decisions regarding required disclosure. Our management, including our chief executive officer and chief financial officer, conducted an evaluation of our disclosure controls and procedures, as defined under Exchange Act Rule 13a-15(e), as of the end of the period covered by this Annual Report on Form 20-F. Based upon that evaluation, our chief executive officer and chief financial officer have concluded that, as of such date, our disclosure controls and procedures were effective.

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 Securities Exchange Act of 1934 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 of 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, 2007. 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, 2007, our internal control over financial reporting is effective.

This annual report does not include an attestation report of our independent registered public accounting firm regarding internal control over financial report. Management's report was not subject to attestation by our independent registered public accounting firm pursuant to temporary rules of the Securities and Exchange Commission that permit us to provide only management's report in this annual report.

CHANGES IN INTERNAL CONTROL OVER FINANCIAL REPORTING

There was no change in our internal control over financial reporting that occurred during the period covered by this annual report that has materially affected, or is reasonably likely to materially affect, our internal controls over financial reporting.

ITEM 16. [RESERVED]

ITEM 16A. AUDIT COMMITTEE FINANCIAL EXPERT

Our board of directors has determined that Mr. Yaacov Goldman, an independent director, meets the definition of an audit committee financial expert, as defined by rules of the Securities and Exchange Commission.

ITEM 16B. CODE OF ETHICS

We have adopted a code of ethics that applies to our chief executive officer and all senior financial officers of our company, including the chief financial officer, chief accounting officer or controller, or persons performing similar functions. Our code of ethics has been filed as an exhibit to this annual report. Written copies are available upon request. If we make any substantive amendment to the code of ethics or grant any waivers, including any implicit waiver, from a provision of the codes of ethics, we will disclose the nature of such amendment or waiver on our website.



ITEM 16C. PRINCIPAL ACCOUNTING FEES AND SERVICES

FEES PAID TO INDEPENDENT PUBLIC ACCOUNTANTS

The following table sets forth, for each of the years indicated, the fees paid to our principal independent registered public accounting firm. All of such fees were pre-approved in advance by our Audit Committee.

| | Year Ended December 31, | |
|---|---|---|
| Services Rendered | 2006 | 2007 |

| | | |
|---|---|---|
| Audit (1) | $ 83,173 | $ 93,000 |
| Audit-related(2) | 8,601 | 15,000 |
| Tax (3) | 20,528 | 7,000 |
| Total | $112,302 | $115,000 |

(1) Audit fees relate to services that would normally be provided in connection with statutory and regulatory filings or engagements, including services that generally only the independent registered public accounting firm can reasonably provide.

(2) Audit-related fees for 2006 and 2007 relate to services provided in connection with the filing of a Report on Form 6-K for the six months period ended June 30, 2006 and the nine month period ended September 30, 2007, respectively.

(3) Tax fees relate to services performed by the tax division for tax compliance, planning, and advice.

PRE-APPROVAL POLICIES AND PROCEDURES

Our audit committee has adopted a policy and procedures for the pre-approval of audit and non-audit services rendered by our independent registered public accountants, Kost Forer Gabbay & Kasierer, a member firm of Ernst & Young Global. Pre-approval of an audit or non-audit service may be given as a general pre-approval, as part of the audit committee's approval of the scope of the engagement of our independent auditor, or on an individual basis. Any proposed services exceeding general pre-approved levels also require specific pre-approval by our audit committee. The policy prohibits retention of the independent public accountants to perform the prohibited non-audit functions defined in Section 201 of the Sarbanes-Oxley Act or the rules of the Securities and Exchange Committee, and also requires the audit committee to consider whether proposed services are compatible with the independence of the public accountants.

ITEM 16D. EXEMPTIONS FROM THE LISTING REQUIREMENTS AND STANDARDS FOR AUDIT COMMITTEE

Not applicable.

ITEM 16E. PURCHASES OF EQUITY SECURITIES BY THE ISSUER AND AFFILIATED PURCHASERS

ISSUER PURCHASE OF EQUITY SECURITIES

Neither we nor any affiliated purchaser has purchased any of our securities during 2007.



PART III

ITEM 17. FINANCIAL STATEMENTS

We have elected to furnish financial statements and related information specified in Item 18.

ITEM 18. FINANCIAL STATEMENTS

CONSOLIDATED FINANCIAL STATEMENTS OF MER TELEMANAGEMENT SOLUTIONS LTD.


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FINANCIAL STATEMENTS OF JUSAN, S.A. AS OF DECEMBER 31, 2006 AND FOR EACH OF THE TWO YEARS ENDED DECEMBER 31, 2005 AND 2006


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ITEM 19. EXHIBITS

Index to Exhibits

| EXHIBIT | DESCRIPTION |
|---|---|
| 1.1 | Memorandum of Association of the Registrant (1) |
| 1.2 | Articles of Association of the Registrant (1) |
| 2.1 | Specimen of Ordinary Share Certificate (1) |
| 4.1 | 1996 Employee Stock Option Plan (1) |



| | |
|---|---|
| 4.2 | Section 102 Stock Option Plan (1) |
| 4.3 | 2003 Israeli Share Option Plan (2) |
| 4.4 | 2006 Stock Option Plan (3) |
| 4.5 | Asset Purchase Agreement dated December 30, 2004 among the |

| | |
|---|---|
| | Registrant and Teleknowledge Group Ltd. (4) |
| 4.6 | Securities Purchase Agreement dated August 10, 2005 among the Registrant and the Investors therein (5) |
| 4.7 | Form of Warrant (6) |
| 4.8 | Registration Rights Agreement dated August 10, 2005 (7) |
| 4.9 | Form of Warrant issued to Mr. Avi Ziv (8) |
| 5.0 | Asset Purchase Agreement dated July 25, 2006 by and among MTS Acquisition Corp. (now named MTS TelSoft Inc.), MTS IntegraTRAK Inc., TelSoft Solutions, Inc. (now named Strategic Sciences Inc.), Consulting Sciences, Inc., Donald Simons and Dale Zuehls (9) |
| 5.1 | Purchase Agreement dated January 24, 2008, by and between the Registrant and Lior Salansky (10) |
| 8.1 | List of Subsidiaries of the Registrant |
| 11.1 | Code of Ethics (11) |
| 12.1 | Certification of Chief Executive Officer pursuant to Rule 13a-14(a) and Rule 15d-14(a) of the Securities Exchange Act, as amended. |
| 12.2 | Certification of Chief Financial Officer pursuant to Rule 13a-14(a) and Rule 15d-14(a) of the Securities Exchange Act, as amended. |
| 13.1 | Certification of Chief Executive Officer pursuant to 18 U.S.C. Section1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002. |
| 13.2 | Certification of Chief Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002. |
| 15.1 | Consent of Kost Forer Gabbay & Kasierer, a Member of Ernst & Young Global |
| 15.2 | Consent of BDO Audiberia Auditores, S.L. |

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(1) Filed as an exhibit to the Registrant's Registration Statement on Form F-1, registration number 333-05814, filed with the Securities and Exchange Commission, and incorporated herein by reference.

(2) Filed as Exhibit 10.3 to the Registrant's Annual Report on Form 20-F for the year ended December 31, 2003, and incorporated herein by reference.



(3) Filed as Appendix B to Item 1 of the Registrant's Report on Form 6-K for the month of June 2006 submitted on June 23, 2006, and

incorporated herein by reference.

(4) Filed as Exhibit 4.1 to the Registrant's Annual Report on Form 20-F for the year ended December 31, 2004, and incorporated herein by reference.

(5) Filed as Item 1 to the Registrant's Report on Form 6-K for the month of August 2005 submitted on August 19, 2005, and incorporated herein by reference.

(6) Filed as Item 3 to the Registrant's Report on Form 6-K for the month of August 2005 submitted on August 19, 2005, and incorporated herein by reference.

(7) Filed as Item 2 to the Registrant's Report on Form 6-K for the month of August 2005 submitted on August 19, 2005, and incorporated herein by reference.

(8) Filed as Exhibit 4.6 to the Registrant's Registration Statement on Form F-3, registration number 333-128225, and incorporated herein by reference.

(9) Filed as Exhibit 5.0 to the Registrants Annual Report on Form 20-F for the year ended December 31, 2006, and incorporated herein by reference.

(10) Filed as Item 2 to the Registrant's Report on Form 6-K for the month of January 2008 submitted on January 28, 2008, and incorporated herein by reference.

(11) Filed as Exhibit 14.1 to the Registrant's Annual Report on Form 20-F for the year ended December 31, 2003, and incorporated herein by reference.



MER TELEMANAGEMENT SOLUTIONS LTD. AND ITS SUBSIDIARIES

CONSOLIDATED FINANCIAL STATEMENTS

AS OF DECEMBER 31, 2007

U.S. DOLLARS IN THOUSANDS

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[ERNST & YOUNG LOGO]

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

TO THE BOARD OF DIRECTORS AND SHAREHOLDERS OF

MER TELEMANAGEMENT SOLUTIONS LTD.

We have audited the accompanying consolidated balance sheets of Mer Telemanagement Solutions Ltd. ("the Company") and its subsidiaries as of December 31, 2006 and 2007, 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, 2007. 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 did not audit the financial statements of Jusan SA, a 50% owned affiliate for the year ended December 31, 2006, in which the Company's investments totaled $ 1,598 thousand and the Company's equity in its income in 2005 and 2006 constitutes $ 2 thousand and $ 159 thousand, respectively. We also did not audit the financial statements of MTS Asia Ltd., a wholly-owned subsidiary, which statements reflect total assets of $ 221 thousand and $ 302 thousand as of December 31, 2007 and 2006, respectively, and total revenues of $ 565 thousand and $ 624 thousand for the years ended December 31, 2007 and 2006, respectively. Those statements were audited by other auditors whose reports have been furnished to us and our opinion, insofar as it relates to amounts emanating from the financial statements of Jusan SA and MTS Asia Ltd., is based solely on the reports of the other auditors.

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. We were not engaged to perform an audit of the Company's internal control over financial reporting. Our audits included consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. We believe that our audits and the reports of other auditors provide a reasonable basis for our opinion.

In our opinion, based on our audits and the reports of the other auditors, the consolidated financial statements referred to above present fairly, in all material respects, the consolidated financial position of the Company and its subsidiaries as of December 31, 2006 and 2007, and the consolidated results of their operations and their cash flows for each of the three years in the period ended December 31, 2007, in conformity with accounting principles generally accepted in the United States.

As discussed in Note 2 to the consolidated financial statements, in 2006, the Company adopted Financial Accounting Standard Board Statement No. 123(R), "Share-Based Payment".

/s/ Kost, Forer, Gabbay & Kasierer
KOST FORER GABBAY & KASIERER
A Member of Ernst & Young Global

Tel-Aviv, Israel
April 2, 2008



MER TELEMANAGEMENT SOLUTIONS LTD.
AND ITS SUBSIDIARIES

CONSOLIDATED BALANCE SHEETS

U.S. DOLLARS IN THOUSANDS

| | 2006 |
|---|---|
| ASSETS | |
| CURRENT ASSETS: | |
| Cash and cash equivalents | $ 1 |
| Short term bank deposits | |
| Marketable securities (Note 3) | |
| Trade receivables (net of allowance for doubtful accounts of $ 505 and $ 882 at December 31, 2006 and 2007, respectively) | 2 |
| Unbilled receivables | |
| Other accounts receivable and prepaid expenses (Note 4) | |
| Investment in other companies (Note 5b) | |
| Inventories | |
| TOTAL current assets | 5 |
| LONG-TERM ASSETS: | |
| Investments in an affiliate (Note 6) | 1 |
| Severance pay fund | |
| Other investments (Note 7) | |
| Deferred income taxes (Note 13) | |
| TOTAL long-term assets | 2 |
| PROPERTY AND EQUIPMENT, NET (Note 8) | |
| OTHER ASSETS: | |
| Goodwill (Note 9a) | 4 |
| Other intangible assets, net (Note 9b) | 1 |
| TOTAL other assets | 5 |
| TOTAL assets | $ 14 |

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



MER TELEMANAGEMENT SOLUTIONS LTD.
AND ITS SUBSIDIARIES

CONSOLIDATED BALANCE SHEETS

U.S. DOLLARS IN THOUSANDS (EXCEPT SHARE AND PER SHARE DATA)

| | 2006 |
|---|---|
| LIABILITIES AND SHAREHOLDERS' EQUITY | |
| CURRENT LIABILITIES: | |
| Short term bank credit and current maturities on bank loan | $ |
| Trade payables | |
| Accrued expenses and other liabilities (Note 10) | 2 |
| Deferred revenues | 1 |
| TOTAL current liabilities | 4 |
| LONG-TERM LIABILITIES: | |
| Long term bank loan (Note 11) | |
| Accrued severance pay | |
| TOTAL long-term liabilities | 1 |
| COMMITMENTS AND CONTINGENT LIABILITIES (Note 12) | |
| SHAREHOLDERS' EQUITY (Note 15): | |
| Share capital - | |
| Ordinary shares of NIS 0.01 par value - Authorized: 12,000,000 shares at December 31, 2006 and 2007; Issued: 5,784,645 shares at December 31, 2006 and 2007; Outstanding: 5,773,845 shares at December 31, 2006 and 2007 | |
| Additional paid-in capital | 16 |
| Treasury shares (10,800 Ordinary shares at December 31, 2006 and 2007) | |
| Accumulated other comprehensive income | |
| Accumulated deficit | (8 |
| TOTAL shareholders' equity | 7 |
| TOTAL liabilities and shareholders' equity | $ 14 |

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



MER TELEMANAGEMENT SOLUTIONS LTD.
AND ITS SUBSIDIARIES

CONSOLIDATED STATEMENTS OF OPERATIONS

U.S. DOLLARS IN THOUSANDS (EXCEPT SHARE AND PER SHARE DATA)

| | YEAR ENDED | |
|---|---|---|
| | 2005 | 20 |
| Revenues (Note 16): | | |
| Product sales | $ 7,628 | $ |
| Services | 3,935 | |
| TOTAL revenues | 11,563 | |
| Cost of revenues: | | |
| Product sales | 2,968 | |
| Services | 834 | |
| TOTAL cost of revenues | 3,802 | |
| Gross profit | 7,761 | |
| Operating expenses: | | |
| Research and development, net of grants from the OCS in the amount of $ 130, $ 578 and $ 469 in 2005, 2006 and 2007, respectively | 4,395 | |
| Selling and marketing | 4,797 | |
| General and administrative | 2,830 | |
| Impairment of goodwill and other intangible assets | - | |
| TOTAL operating expenses | 12,022 | |
| Operating loss | (4,261) | |
| Financial income (expenses), net | 53 | |
| Capital loss on sale of long-term investment | | |
| Loss before taxes on income | (4,208) | |
| Taxes on income (benefit), net (Note 13) | 10 | |
| Loss before equity in earnings (loss) of affiliate | (4,218) | |

| | | |
|---|---|---|
| Equity in earnings (loss) of affiliate | 2 | |
| Net loss | $ (4,216) | $ |
| Net loss per share: | | |
| Basic and diluted net loss per Ordinary share | $ (0.83) | $ |
| Weighted average number of Ordinary shares used in computing basic and diluted net loss per share | 5,092,117 | 5,7 |

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



MER TELEMANAGEMENT SOLUTIONS LTD.
AND ITS SUBSIDIARIES

CONSOLIDATED STATEMENTS OF CHANGES IN SHAREHOLDERS' EQUITY

U.S. DOLLARS IN THOUSANDS

| | SHARE CAPITAL | |
|---|---|---|
| | NUMBER | AMOUNT |
| Balance as of January 1, 2005 | 4,638,004 | $ 14 |
| Issuance of shares, net | 937,500 | 2 |
| Exercise of options | 158,000 | 1 |
| Stock based compensation related to warrants issued to non employees | - | - |
| Amortization of deferred stock compensation | - | - |
| Other comprehensive loss: | | |
| Unrealized losses on available-for-sale marketable securities, net | - | - |
| Foreign currency translation adjustments | - | - |
| Total other comprehensive loss | | |
| Net loss | - | - |
| Total comprehensive loss | | |
| Balance as of December 31, 2005 | 5,733,504 | 17 |
| Exercise of options | 40,341 | (*) - |
| Stock based compensation related to warrants issued to non employees | - | - |
| Stock based compensation related to options issued to employees | - | - |
| Reclassification of deferred stock compensation due to implementation of SFAS 123R | - | - |
| Other comprehensive loss: | | |
| Unrealized gains on available-for-sale marketable securities, net | - | - |
| Foreign currency translation adjustments | - | - |
| Total other comprehensive income | - | - |
| Net loss | - | - |

| | | |
|---|---|---|
| Total comprehensive loss | | |
| Balance as of December 31, 2006 | 5,773,845 | 17 |
| Stock based compensation related to options issued to employees | - | - |
| Other comprehensive loss: | | |
| Unrealized gains on available-for-sale marketable securities, net | - | - |
| Foreign currency translation adjustments | - | - |
| Total other comprehensive income | - | - |
| Net loss | - | - |
| Total comprehensive loss | | |
| Balance as of December 31, 2007 | 5,773,845 | $ 17 |

Accumulated unrealized gains from available-for-sale marketable securities

| | ACCUMULATED OTHER COMPREHENSIVE INCOME (LOSS) | ACCUMUL EARNIN DEFIC |
|---|---|---|
| Balance as of January 1, 2005 | $ 348 | $ (2 |
| Issuance of shares, net | - | |
| Exercise of options | - | |
| Stock based compensation related to warrants issued to non employees | - | |
| Amortization of deferred stock compensation | - | |
| Other comprehensive loss: | | |
| Unrealized losses on available-for-sale marketable securities, net | (76) | |
| Foreign currency translation adjustments | (347) | |
| Total other comprehensive loss | | |
| Net loss | - | (4 |
| Total comprehensive loss | | |
| Balance as of December 31, 2005 | (75) | (6 |
| Exercise of options | - | |
| Stock based compensation related to warrants issued to non employees | - | |
| Stock based compensation related to options issued to employees | - | |
| Reclassification of deferred stock compensation due to implementation of SFAS 123R | - | |
| Other comprehensive loss: | | |
| Unrealized gains on available-for-sale marketable securities, net | 1 | |
| Foreign currency translation adjustments | 328 | |
| Total other comprehensive income | - | |
| Net loss | - | (2 |
| Total comprehensive loss | | |
| Balance as of December 31, 2006 | 254 | (8 |
| Stock based compensation related to options issued to employees | - | |
| Other comprehensive loss: | | |
| Unrealized gains on available-for-sale marketable securities, net | 1 | |
| Foreign currency translation adjustments | (243) | |
| Total other comprehensive income | - | |
| Net loss | - | (5 |

| | | |
|---|---|---|
| Total comprehensive loss | | |
| Balance as of December 31, 2007 | $ 12 | $ (14 |
| Accumulated unrealized gains from available-for-sale marketable securities | $ 12 | |

*) Represents an amount lower than $ 1.

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



MER TELEMANAGEMENT SOLUTIONS LTD.
AND ITS SUBSIDIARIES

CONSOLIDATED STATEMENTS OF CASH FLOWS

U.S. DOLLARS IN THOUSANDS

| | YEAR ENDED | |
|---|---|---|
| | 2005 | 2 |
| CASH FLOWS FROM OPERATING ACTIVITIES: | | |
| Net loss | $ (4,216) | $ ( |
| Adjustments required to reconcile net loss to net cash used in operating activities: | | |
| Gains on sale of available-for-sale marketable securities | (77) | |
| Loss on sale of an affiliate | - | |
| Loss on sale of other investments | - | |
| Impairment of other investments | 27 | |
| Impairment of goodwill and other intangible assets | - | |
| Equity in earnings of affiliate | (2) | |
| Depreciation and amortization | 655 | |
| Deferred income taxes, net | 10 | |
| Employee stock-based compensation | 66 | |
| Stock based compensation related to warrants issued to non employees | 156 | |
| Accrued severance pay, net | 119 | |
| Decrease (increase) in trade receivables and unbilled receivables | (672) | |
| Decrease (increase) in other accounts receivable and prepaid expenses | (99) | |
| Decrease (increase) in inventories | (3) | |
| Increase (decrease) in trade payables | 16 | |
| Increase (decrease) in accrued expenses and other liabilities | (46) | |
| Increase (decrease) in deferred revenues | (366) | |
| Decrease in lease deposits | - | |
| Increase (decrease) in related parties, net | 15 | |
| Net cash used in operating activities | (4,417) | ( |

| | | |
|---|---|---|
| CASH FLOWS FROM INVESTING ACTIVITIES: | | |
| Proceeds from sale of property and equipment | 7 | |
| Proceeds from sale of an affiliate | - | |
| Purchase of property and equipment | (251) | |
| Investment in short term bank deposit | - | |
| Investment in lease deposits | (26) | |
| Investment in available-for-sale marketable securities | (163) | |
| Proceeds from sale of available-for-sale marketable securities | 1,089 | |
| Additional investment in goodwill in consideration of TeleKnowledge acquisition | (21) | |
| Acquisition of certain assets and liabilities of Telsoft (a) | - | ( |
| Dividend from an affiliate | 195 | |
| Others | 63 | |
| Net cash provided by (used in) investing activities | 893 | ( |

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



MER TELEMANAGEMENT SOLUTIONS LTD.
AND ITS SUBSIDIARIES

CONSOLIDATED STATEMENTS OF CASH FLOWS

U.S. DOLLARS IN THOUSANDS

| | YEAR ENDED | |
|---|---|---|
| | 2005 | 2 |
| CASH FLOWS FROM FINANCING ACTIVITIES: | | |
| Proceeds from long term loan | $ - | $ |
| Proceeds from short term bank credit | - | |
| Repayment of long-term loans | - | |
| Proceeds from issuance of shares and warrants, net | 2,625 | |
| Proceeds from exercise of options and warrants | 281 | |
| Net cash provided by (used in) financing activities | 2,906 | |
| Effect of exchange rate changes on cash and cash equivalents | (5) | |
| Decrease in cash and cash equivalents | (623) | ( |
| Cash and cash equivalents at the beginning of the year | 3,814 | |
| Cash and cash equivalents at the end of the year | $ 3,191 | $ |

SUPPLEMENTAL DISCLOSURE OF CASH FLOWS ACTIVITIES:

Cash paid during the year for:

| | | |
|---|---|---|
| Interest | $ 3 | $ |
| Income taxes | $ 17 | $ |

(a) IN CONJUNCTION WITH THE ACQUISITIONS, THE FAIR VALUES OF ASSETS ACQUIRED AND LIABILITIES ASSUMED AT THE DATE OF ACQUISITION WERE AS FOLLOWS (SEE NOTE 1d):

| | | |
|---|---|---|
| Working capital (excluding cash and cash equivalents) | $ - | $ |
| Property and equipment | - | |
| Goodwill | - | |
| Developed technology | - | |
| Customer relationship | - | |
| | $ - | $ |

(b) SUPPLEMENTAL DISCLOSURE OF NON-CASH ACTIVITIES:

| | | |
|---|---|---|
| Sale of other investments | - | |
| Earn out in respect of Telsoft acquisition | - | |
| Earn out in respect of Teleknowledge acquisition | $ 264 | $ |

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

a. Mer Telemanagement Solutions Ltd. ("the Company" or "MTS") was incorporated on December 27, 1995. MTS and its subsidiaries ("the Group") design, develop, market and support a comprehensive line of telecommunication management and customer care & billing ("CC&B") solutions that enable business organizations and other enterprises to improve the efficiency and performance of all IP operations, and reduce associated costs. The Group products include call accounting and management products, fault management systems and web based management solutions for converged voice, voice over Internet Protocol, IP data and video and CC&B solutions. As for MTS's subsidiaries, see Note 17.

b. MTS's products are designed to provide telecommunication and information technology managers with tools to reduce communication costs, recover charges payable by third parties, and to detect and prevent abuse and misuse of telephone networks

including fault telecommunication usage.

The Group markets its products worldwide through distributors, business telephone switching systems manufacturers and vendors and its direct sales force. Several international private automatic branch exchange ("PBX") manufacturers market the Group's products as part of their PBX selling efforts or on an Original Equipment Manufacturer ("OEM") basis. The Group is highly dependent upon the active marketing and distribution of its OEM's. If the Group is unable to effectively manage and maintain a relationship with its OEM or any event negatively affecting such dealer's financial condition, could cause a material adverse effect on the Group's results of operations and financial position. In 2005, 2006 and 2007, one major customer generated 36%, 29% and 27% of the Group's revenues, respectively.

Certain components and subassemblies included in the Group's products are obtained from a single source or a limited group of suppliers and subcontractors. If such supplier fails to deliver the necessary components or subassemblies, the Company may be required to seek alternative sources of supply. A change in supplier could result in manufacturing delays, which could cause a possible loss of sales and, consequently, could adversely affect the Company's results of operations and financial position.

MTS's shares are listed for trade on the Nasdaq Capital Market.

The Company has an accumulated deficit of approximately $ 14,632 and has negative working capital of $2,014 as of December 31, 2007. On November 2007, the Company sold its 50% ownership interest in Jusan S.A. in consideration of 700 Euros (approximately $1,031). In addition, in February, 2008 the company consummated the sale of its ownership interest in Cvidya, in consideration of approximately $ 603. Moreover, on January 24, 2008, the Company and a private investor entered into a definitive agreement for a private placement of 750,000 ordinary shares at a price per share of $ 1 for the aggregate purchase price of $ 750.

c. On December 30, 2004, the Company and Teleknowledge Group Ltd. ("Teleknowledge") consummated an Assets Purchase Agreement ("the Agreement"). TeleKnowledge is a leading provider of carrier-class billing and rating solutions. The integration of Teleknowledge's billing solution enables MTS to offer an end-to-end customer care and billing solution. Under the terms of the Agreement, the Company acquired certain assets and liabilities of Teleknowledge for the following consideration:

1. An initial consideration of $ 2,374 in cash.





NOTE 1:- GENERAL (CONT.)

2. Additional contingent consideration of up to an amount of $ 3,650, based on post acquisition revenue performance (calculated as 10% of renewal maintenance fees and 20% of all other revenues from sales which included Teleknowledge products), over a period of three years. Such payments will be recorded as additional goodwill, during the contingency period, when actual revenue performance will be evaluated (see Note 9a). In 2005, 2006 and 2007 additional considerations of $285 $192 and $85, respectively, were recorded, in accordance with the agreement.

3. In addition, the Company incurred transaction costs totaling $ 71.

Prior to the acquisition, MTS and Teleknowledge had an OEM relationship. The commercial arrangements and transactions were settled before the date of the acquisition.

The acquisition was accounted for under the purchase method of accounting in accordance with SFAS 141, "Business Combination" ("SFAS 141"). Accordingly, the purchase price has been allocated to the assets acquired and the liabilities assumed based on the estimated fair value at the date of acquisition. The excess of the purchase price over the estimated fair value of the net assets acquired has been recorded as goodwill.

Based upon a valuation of the tangible and intangible assets acquired and the liabilities assumed, the Company has allocated the total cost of the acquisition to Teleknowledge's net assets at the date of acquisition, as follows:

| | |
|---|---|
| Trade receivables | $ 100 |
| Property and equipment | 40 |
| Intangible assets: | |
| Developed technology (four-year useful life) | 690 |
| Customer relationship (six-year useful life) | 300 |
| Goodwill | 1,391 |
| Total assets acquired | 2,521 |
| Liabilities assumed - Deferred revenues | (76) |
| Net assets acquired | $ 2,445 |

The valuation of the Company's developed technology was based on the income approach, which reflects the future economic benefits from Teleknowledge products. The value assigned to customer relationship was based on the cost approach. Under this approach, the customer relationship was valued by calculating the savings realized by the Company through obtaining a pre-existing customer relationship of Teleknowledge.

During the second quarter of 2007, the Company reviewed its goodwill and determined that there was an indication that the goodwill relating to the acquisition of the Teleknowledge billing activity had been impaired. The Company assessed the recoverable amount of such goodwill, based on its projections and using expected future discounted operating cashflows. Based on such review, the Company determined that the goodwill and other

intangible assets relating to the acquisition of the Teleknowledge billing activity in the amount of $2,312 had been impaired and the carrying value was written-off.





NOTE 1:- GENERAL (CONT.)

d. On July 25, 2006, the Company and Telsoft Solutions, Inc. ("Telsoft") consummated an Asset Purchase Agreement ("APA"). Telsoft is a provider of call accounting and TEM solutions to organizations and the acquisition shall enable the Company to increase its customer base. Under the terms of the APA, the Company acquired certain assets and assumed certain enumerated liabilities of Telsoft for the following consideration:

1. An initial consideration of $ 1,100 in cash.

2. Additional earn-out payments based on revenue milestones for the 12 months period following the acquisition. Such payments were recorded as additional goodwill during 2007, when actual revenue performance was evaluated (see Note 9a).

The acquisition was completed on July 31, 2006.

In order to finance the acquisition, the Company signed a loan agreement with Bank Hapoalim (the "Bank"), according to which the Bank granted the Company a loan in the amount of approximately $ 1,000 (see also Note 11).

The acquisition was accounted for under the purchase method of accounting in accordance with SFAS 141, "Business Combination" ("SFAS 141"). Accordingly, the purchase price has been allocated to the assets acquired and the liabilities assumed based on the estimated fair value at the date of acquisition. The excess of the purchase price over the estimated fair value of the net assets acquired has been recorded as goodwill.

Based upon a valuation of the tangible and intangible assets acquired and the liabilities assumed, the Company has allocated the total cost of the acquisition to TelSoft's net assets at the date of acquisition, as follows:

| | |
|---|---|
| Property and equipment | 5 |
| Intangible assets: | |
| Developed technology - Product A (six-year useful life) | 270 |
| Developed technology - Product B (four-year useful life) | 163 |
| Customer relationship (six-year useful life) | 645 |
| Goodwill | 166 |
| Total assets acquired | 1,249 |
| Liabilities assumed - Deferred maintenance | (47) |

| | |
|---|---|
| Net assets acquired | $ 1,202 |

The valuation of the Company's developed technology was based on the income approach, which reflects the future economic benefits from TelSoft products. The value assigned to customer relationship was based on the income approach. The fair value of customer relationship was estimated by discounting to present value, the cash flows that will be derived from TelSoft's customers retained by MTS.

Goodwill, including accumulated earn-out in the amount of $606, as of December 31, 2007 amounted to $ 772.





NOTE 1:- GENERAL (CONT.)

Pro forma results (Unaudited):

The following unaudited proforma information does not purport to represent what the Company's results of operations would have been had the acquisitions occurred on January 1, 2006, nor does it purport to represent the results of operations of the Company for any future period.

| | YEAR ENDED DECEMBER 31, 2006 |
|---|---|
| Revenues | $ 12,032 |
| Net loss from continuing operations | $ (1,888) |
| Basic and diluted net loss per share for continuing operations | $ (0.33) |
| Weighted average number of Ordinary shares in computation of basic and diluted net loss per share | 5,762,311 |

NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES

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

a. Use of estimates:

The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the amounts reported in the financial statements and accompanying notes. Actual results could differ from those estimates.

b. Financial statements in U.S. dollars:

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

Accordingly, monetary accounts maintained in currencies other than the dollar are remeasured into dollars in accordance with SFAS No. 52, "Foreign Currency Translation". All transaction gains and losses of the remeasurement of monetary balance sheet items are reflected in the consolidated statements of operations as financial income or expenses, as appropriate.





NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES (CONT.)

For those foreign subsidiaries and affiliates, whose functional currency has been determined to be their local currency, assets and liabilities are translated at the year end exchange rates and statements of operations items are translated at the average exchange rate prevailing during the period. The resulting translation adjustments are recorded as a separate component of accumulated other comprehensive income (loss) in shareholders' equity.

c. Principles of consolidation:

The consolidated financial statements include the accounts of MTS and its wholly-owned subsidiaries. Intercompany transactions and balances, including profits from intercompany sales not yet realized outside the Group, have been eliminated upon consolidation.

d. Cash equivalents:

The Company considers all short-term highly liquid investments that are readily convertible to cash with original maturities of three months or less to be cash equivalents.

e. Marketable securities:

The Company accounts for investments in debt and equity securities (other than those accounted for under the equity method of accounting) in accordance with Statement of Financial Accounting Standard No. 115, "Accounting for Certain Investments in Debt and Equity Securities" ("SFAS No. 115").

Management determines the classification of investments in marketable debt and equity securities at the time of purchase and reevaluates such determinations at each balance sheet date.

The Company classifies all of its 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.

Interest and dividends on securities are included in financial income, net.

f. Inventories:

Inventories are stated at the lower of cost or market value. Inventory write-offs and write-down provisions are provided to cover risks arising from slow moving items or technological obsolescence.

The Company and its subsidiaries periodically evaluate the quantities on hand relative to current and historical selling prices and historical and projected sales volume. Based on this evaluation, provisions are recorded when required to write-off inventory according to its market value. The provision for obsolescence inventory amounted to $72 for the year ended December 31, 2007.





NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES (CONT.)

Cost is determined as follows:

Raw materials - using the "first in, first out" method.

Finished products are recorded on the basis of direct manufacturing costs with the addition of allocable indirect manufacturing costs.

g. Investments in an affiliate:

In these financial statements, the affiliated company is Jusan S.A., a company held at a rate of 50% (which is not a subsidiary), where the Company can exercise significant influence over the operating and financial policy of the affiliate.

The investment in the affiliate is accounted for by the equity method, in accordance with Accounting Principle Board Opinion No.18, "The Equity Method of Accounting for Investments in Common Stock", ("APB No.18"). Profits on intercompany sales, not realized through sales to third parties, were eliminated. The excess of the purchase price over the fair value of net tangible assets acquired has been attributed to goodwill.

Goodwill is reviewed annually (or more frequently if circumstances indicate impairment has occurred) for impairment in accordance with the provisions of Statement of Financial Accounting Standard No. 142, "Goodwill and Other Intangible Assets" ("SFAS No. 142").

Under APB 18, an impairment of value of an investment accounted for under the equity method, which is other than a temporary decline, should be recognized as a realized loss, establishing a new carrying value for the investment. Factors the Company considers in making this evaluation include: the length of time and the extent to which the market value has been lower than cost, the financial condition and near-term prospects of the issuer, including cash flows of the investee and any specific events which may influence the operations of the issuer and the intent and ability of the Company to retain its investments for a period of time sufficient to allow for any anticipated recovery in market value. A current fair value of an investment that is less than its carrying amount may indicate an impairment of value of the investment. During 2007 the Company recorded an equity loss of $197 from the sale of Jusan S.A. (see also Note 6).

h. Investment in other companies:

The investment in these companies is stated at cost, since the Group does not have the ability to exercise significant influence over operating and financial policies of those investments. The Company's investments in other companies are reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of an investment may not be recoverable, in accordance with APB No.18. As of December 31, 2007 the Company recorded $63 loss from investment in other companies (see also Note 5).





NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES (CONT.)

i. Property and equipment:

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

| | % |
|---|---|
| Computers and peripheral equipment | 33 |
| Office furniture and equipment | 6 - 20 |
| Motor vehicles | 15 |
| Leasehold improvements | Shorter of useful life or lease term |

j. Impairment of long-lived assets:

The Company's long-lived assets and certain identifiable intangibles are reviewed for impairment in accordance with Statement of Financial Accounting Standard No. 144, "Accounting for the Impairment or Disposal of Long-Lived Assets" ("SFAS No. 144"), whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. Recoverability of assets to be held and used is measured by a comparison of the carrying amount of an asset 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, 2007, no impairment losses have been identified.

k. Goodwill:

Goodwill has been recorded as a result of acquisitions. Goodwill is not amortized, but rather is subject to an annual impairment test. SFAS No. 142 requires goodwill to be tested for impairment at least annually or between annual tests if certain events or indicators of impairment occur. The impairment test consists of a comparison of the fair value of goodwill with its carrying amount. If the carrying amount of goodwill exceeds its fair value, an impairment loss is recognized in an amount equal to that excess. Goodwill is tested for impairment at the reporting unit level by a comparison of the fair value of a reporting unit with its carrying amount. The Company has elected to perform its analysis of goodwill at the end of the third quarter of the year. During 2007, impairment loss in the amount of $1,878 was identified and recorded (see also Note 9a).

l. Intangible assets:

Intangible assets are amortized over their useful lives using a method of amortization that reflects the pattern in which the economic benefits of the intangible assets are consumed or otherwise used up, in accordance with SFAS 142. Developed technology is amortized over a weighted average of four-six years and customer relationship is amortized over a period of six years. As for capitalized software costs, see n below. During 2007 an impairment loss of intangible assets in the amount of $434 was recorded (see also Note 9d).

U.S. DOLLARS IN THOUSANDS (EXCEPT SHARE AND PER SHARE DATA)

NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES (CONT.)

m. Revenue recognition:

The Company generates revenues mainly from licensing the rights to use its software products. Certain software licenses require significant customization. The Company also generates revenues from rendering maintenance, service bureau, support and training. The Company sells its products directly to end-users and indirectly through resellers and OEM's (who are considered end users).

Revenues from software license agreements are recognized when all criteria outlined in Statement of Position No. 97-2, "Software Revenue Recognition" ("SOP No. 97-2") as amended are met. Revenue from license fees is recognized when persuasive evidence of an agreement exists, delivery of the product has occurred, no significant obligations with regard to implementation remain, the fee is fixed or determinable and collectibility is probable. The Company does not grant a right of return to its customers.

Where software arrangements involve multiple elements, revenue is allocated to each undelivered element based on vendor specific objective evidence ("VSOE") of the fair values of each undelivered element in the arrangement, in accordance with the "residual method" prescribed by SOP No. 98-9, "Modification of SOP No. 97-2, Software Revenue Recognition with Respect to Certain Transactions". The VSOE used by the Company to allocate the sales price to support services and maintenance is based on the renewal rate charged when these elements are sold separately. License revenues are recorded based on the residual method. Under the residual method, revenue is recognized for the delivered elements when (1) there is VSOE of the fair values of all the undelivered elements, and (2) all revenue recognition criteria of SOP No. 97-2, as amended, are satisfied. Under the residual method any discount in the arrangement is allocated to the delivered element. If sufficient specific objective evidence does not exist for all undelivered elements, revenue is deferred for the entire arrangement until all revenue recognition criteria are met for such undelivered elements.

Revenues from maintenance and support services are recognized over the term of the maintenance and support agreement on a straight line basis.

Deferred revenues include unearned amounts received under maintenance and support contracts, not yet recognized as revenues.

Revenues from billing products which involve significant customization of the Company's software to customer specific specifications are recognized in accordance with Statement of Position 81-1, "Accounting for Performance of Construction-Type and Certain Production- Type Contracts", using contract accounting on a percentage of completion method, over the period from signing of the license through to customer acceptance in accordance with the "Input Method". The amount of revenue recognized is based on the total arrangement and the percentage to completion achieved. The percentage to completion is measured by monitoring progress using records of actual costs incurred to

date in the project compared with the total estimated project requirement. Estimates of total project requirements are based on prior experience of customization, delivery and acceptance of the same or similar technology and are reviewed and updated regularly by management.





NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES (CONT.)

After delivery, if uncertainty exists about customer acceptance of the software, license revenue is not recognized until acceptance. Provisions for estimated losses on uncompleted contracts are made in the period in which such losses are first determined, in the amount of the estimated loss on the entire contract. As of December 31, 2007, no such estimated losses were identified.

Estimated gross profit or loss from long-term contracts may change due to changes in estimates resulting from differences between actual performance and original forecasts. Such changes in estimated gross profit are recorded in results of operations when they are reasonably determinable by management, on a cumulative catch-up basis.

The Company believes that the use of the percentage of completion method is appropriate as the Company has the ability to make reasonably dependable estimates of the extent of progress towards completion, contract revenues and contract costs. In addition, contracts executed include provisions that clearly specify the enforceable rights regarding services to be provided and received by the parties to the contracts, the consideration to be exchanged and the manner and terms of settlement. In all cases the Company expects to perform its contractual obligations and its licensees are expected to satisfy their obligations under the contract.

Where arrangements recognized according to SOP 81-1 involve maintenance and support services, revenues are recognized according to Emerging Issues Task Force ("EITF"), Issue No. 00-21 "Revenue Arrangement with Multiple Deliverables" ("EITF 00-21").

According to EITF 00-21 a multiple-element arrangement (an arrangement that involves the delivery or performance of multiple products, services and/or rights to use assets) is separated into more than one unit of accounting, if the functionality of the delivered element is not dependent on the undelivered element, there is vendor-specific objective evidence (VSOE) of fair value of the undelivered element and delivery of the delivered element(s) represents the culmination of the earnings process for these elements. The Company has established VSOE for maintenance and support services based on the renewal rate charged when these elements are sold separately and therefore, the arrangement consideration is allocated to maintenance and support services

based on their relative VSOE.

n. Research and development costs:

Statement of Financial Accounting Standards No. 86, "Accounting for the Costs of Computer Software to be Sold, Leased or Otherwise Marketed" ("SFAS No. 86"), requires capitalization of certain software development costs subsequent to the establishment of technological feasibility. Based on the Company's and its subsidiaries' product development process, technological feasibility is established upon completion of a working model.

Research and development costs incurred in the process of developing product improvements or new products, are generally charged to expenses as incurred, net of grants received from the Office of the Chief Scientist of Israel's Ministry of Industry, Trade and Labor (see Note 12b).





NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES (CONT.)

Significant costs incurred by the Company and its subsidiaries between completion of the working model and the point at which the product is ready for general release, have been capitalized.

Capitalized software costs are amortized by the greater of the amount computed using the: 1) ratio that current gross revenues from sales of the software to the total of current and anticipated future gross revenues from sales of that software, or 2) the straight-line method over the estimated useful life of the product (three years). The Company assesses the recoverability of this intangible asset on a regular basis by determining whether the amortization of the asset over its remaining life can be recovered through undiscounted future operating cash flows from the specific software product sold.

o. Government grants:

Royalty-bearing grants from the Government of Israel for funding certain approved research and development projects are recognized at the time the Company is entitled to such grants, on the basis of the related costs incurred and recorded as a deduction of research and development costs. Research and development grants amounted $ 130, $ 578 and $ 469 in 2005, 2006 and 2007, respectively. Total royalties accrued or paid amounted to $ 198, $ 187 and $ 178 in 2005, 2006 and 2007, respectively and were recorded as part of the cost of goods sold.

p. Income taxes:

The Company accounts for income taxes, in accordance with Statement of Financial Accounting Standard No. 109, "Accounting

for Income Taxes" ("SFAS No. 109"). This statement prescribes the use of the liability method whereby deferred tax assets and liability account balances are determined based on differences between financial reporting and tax bases of assets and liabilities and are measured using the enacted tax rates and laws that will be in effect when the differences are expected to reverse. Valuation allowances are provided to reduce deferred tax assets to their estimated realizable value.

In July 2006 the FASB issued Interpretation, or FIN, No. 48, "Accounting for Uncertainty in Income Taxes - an Interpretation of FASB Statement No. 109", or FIN 48. FIN 48 provides detailed guidance for the financial statement recognition, measurement and disclosure of uncertain tax positions recognized in an enterprise's financial statements in accordance with SFAS 109. Income tax positions must meet a more-likely-than-not recognition threshold at the effective date to be recognized upon the adoption of FIN 48 and in subsequent periods. The Company adopted FIN 48 effective January 1, 2007 and the provisions of FIN 48 have been applied to all income tax positions commencing from that date. As of January 1, 2007 there was no difference between the provisions of SFAS 109 and FIN 48 therefore no adjustment was recorded to the retained earnings.

Prior to 2007 the Company determined its tax contingencies in accordance with SFAS 5, Accounting for Contingencies, or SFAS 5. The Company recorded estimated tax liabilities to the extent the contingencies were probable and could be reasonably estimated.





NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES (CONT.)

q. Accounting for stock-based compensation:

On January 1, 2006, the Company adopted SFAS No. 123 (revised 2004), "Share-Based Payment" ("SFAS No. 123(R)") which requires the measurement and recognition of compensation expense based on estimated fair values for all share-based payment awards made to employees and directors. SFAS No. 123(R) supersedes Accounting Principles Board Opinion No. 25, "Accounting for Stock Issued to Employees" ("APB No. 25"), for periods beginning in fiscal year 2006. In March 2005, the Securities and Exchange Commission issued Staff Accounting Bulletin No. 107 ("SAB 107") relating to SFAS No. 123(R). The Company has applied the provisions of SAB 107 in its adoption of SFAS No. 123(R). SFAS No. 123(R) 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 operations statements.

Prior to the adoption of SFAS No. 123(R), the Company accounted for equity-based awards to employees and directors using the

intrinsic value method in accordance with APB No. 25 as allowed under SFAS No. 123, "Accounting for Stock-Based Compensation" ("SFAS No. 123"). Pursuant to these accounting standards, the Company recorded deferred compensation for stock options granted to employees at the date of grant equal to the excess of the market value of the underlying shares at that date over the exercise price of the options.

The Company adopted SFAS No. 123(R) using the modified prospective transition method, which requires the application of the accounting standard starting from January 1, 2006, the first day of the Company's fiscal year 2006. Under that transition method, compensation cost recognized in the year ended December 31, 2006, includes: (a) compensation cost for all share-based payments granted prior to, but not yet vested as of January 1, 2006, based on the grant date fair value estimated in accordance with the original provisions of SFAS No. 123, and (b) compensation cost for all share-based payments granted subsequent to January 1, 2006, based on the grant-date fair value estimated in accordance with the provisions of SFAS No. 123(R). Results for prior periods have not been restated.

The Company recognizes compensation expenses for the value of its awards granted subsequent to January 1, 2006 based on the straight line method over the requisite service period of each of the awards, net of estimated forfeitures. SFAS No. 123(R) requires forfeitures to be estimated at the time of grant and revised, if necessary, in subsequent periods if actual forfeitures differ from those estimates. Estimated forfeitures are based on actual historical pre-vesting forfeitures. Forfeitures were previously accounted for as they occurred, but have been estimated with the adoption of SFAS No. 123(R) for those awards not yet vested. For awards granted prior to January 1, 2006, the Company recognizes compensation expenses based on the accelerated attribution method over the requisite service period of each of the awards.

The Company estimates the fair value of stock options granted using the Black-Scholes- option pricing model. The option-pricing model requires a number of assumptions, of which the most significant are the expected stock price volatility and the expected option term. Expected volatility was calculated based upon actual historical stock price movements. The expected term of options granted is based upon historical experience and represents the period of time that options granted are expected to be outstanding. The risk-free interest rate is based on the yield from U.S. treasury bonds with an equivalent term. The Company has historically not paid dividends and has no foreseeable plans to pay dividends.





NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES (CONT.)

The fair value for options granted in 2005, 2006 and 2007 is estimated at the date of grant using a Black-Scholes options pricing model with the following weighted average assumptions:

| | YEAR ENDED DECEMBER 31, | | |
|---|---|---|---|
| EMPLOYEE STOCK OPTIONS | 2005 | 2006 | 2007 |
| Expected volatility | 56.9% | 74.5% | 45.4% |
| Risk-free interest | 3.9% | 4.6% | 4.2% |
| Dividend yield | 0.0% | 0.0% | 0.0% |
| Expected life (years) | 4 | 4 | 4 |

The following table illustrates the effect on 2005 net loss and earnings per share, assuming that the Company had applied the fair value recognition provision of SFAS No. 123 on its stock-based employee compensation:

| | YEAR ENDED DECEMBER 31, 2005 |
|---|---|
| Net loss available to Ordinary shares, as reported | $ (4,216) |
| Add: Stock-based employee compensation - intrinsic value | 66 |
| Deduct: Stock-based compensation expense determined under fair value method for all awards, net of related tax effect | (264) |
| Pro forma net loss | $ (4,414) |
| Basic and diluted net loss per share, as reported | $ (0.83) |
| Basic and diluted net loss per share, pro forma | $ (0.87) |

r. Fair value of financial instruments:

The following methods and assumptions were used by the Group in estimating its fair value disclosures for financial instruments:

The carrying amounts of cash and cash equivalents, short-term bank deposits, trade receivables, other accounts receivable, short-term bank credit and trade payables approximate their fair value, due to the short-term maturity of such instruments.

The fair value for marketable securities is based on quoted market prices (see Note 3).

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

U.S. DOLLARS IN THOUSANDS (EXCEPT SHARE AND PER SHARE DATA)

NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES (CONT.)

s. Severance pay:

The Company's liability for severance pay is calculated pursuant to Israel's Severance Pay Law based on the most recent salary of the employees multiplied by the number of years of employment, as of the balance sheet date. Employees are entitled to one month's salary for each year of employment or a portion thereof. The Company's liability for all of its employees is fully provided by monthly deposits with insurance policies and by an accrual. The value of these policies is recorded as an asset in the Company's balance sheet.

The deposited funds may be withdrawn only upon the fulfillment of the obligation pursuant to Israel's Severance Pay Law or labor agreements. The value of the deposited funds is based on the cash surrendered value of these policies, and includes immaterial profits.

Severance expense for the years ended December 31, 2005, 2006 and 2007 amounted to approximately $ 585, $ 339 and $ 400, respectively.

t. Concentrations of credit risk:

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

Cash and cash equivalents and short-term bank deposits are deposited with major banks in Israel and major banks in United States. Such deposits in the U.S. may be in excess of insured limit and are not insured in other jurisdictions. Management believes that the financial institutions that hold the Company's investments are financially sound, and accordingly, minimal credit risk exists with respect to these investments.

The customers of the Company are located mainly in the U.S. and Europe (see Note 16). The Company performs ongoing credit evaluations of its customers. In certain circumstances, the Company may require letters of credit, other collateral or additional guarantees. The allowance for doubtful accounts is determined with respect to specific debts that are doubtful of collection according to management estimates.

The Company's marketable securities include investments in equity securities and Israeli government securities. Management believes that the portfolio is well diversified, and accordingly, minimal credit risk exists with respect to these marketable securities.

The Company has no off-balance-sheet concentration of credit risk such as foreign exchange contracts, option contracts or other foreign hedging arrangements.

u. Basic and diluted loss per share:

Basic net loss per share is computed based on the weighted average number of Ordinary shares outstanding during each year. The total number of shares related to the outstanding options excluded from the calculation of diluted net loss per share was 1,011,584, 685,410 and 602,487 for the years ended December 31, 2005, 2006 and 2007, respectively.





NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES (CONT.)

v. Impact of recently issued accounting standards:

In September 2006, the FASB issued Statement of Financial Accounting Standards ("SFAS") No. 157, "Fair Value Measurements," ("SFAS No. 157"). SFAS No. 157 provides a single definition of fair value, a framework for measuring fair value, and expanded disclosures concerning fair value. Previously, different definitions of fair value were contained in various accounting pronouncements creating inconsistencies in measurement and disclosures. SFAS No. 157 applies under those previously issued pronouncements that prescribe fair value as the relevant measure of value, except SFAS No. 123(R) and related interpretations. SFAS No. 157 does not apply to accounting standards that require or permit measurement similar to fair value but are not intended to measure fair value. SFAS No. 157 is effective for fiscal years beginning after November 15, 2007. The Company is currently evaluating the impact of the adoption of SFAS No. 157.

In February 2007, the FASB issued SFAS No. 159, "The Fair Value Option Financial Assets and Financial Liabilities," ("SFAS No. 159"). SFAS No. 159 for provides companies with an option to report selected financial assets and liabilities at fair value. Generally accepted accounting principles have required different measurement attributes for different assets and liabilities that can create artificial volatility in earnings. The Standard's objective is to reduce both complexity in accounting for financial instruments and the volatility in earnings caused by measuring related assets and liabilities differently. SFAS No. 159 is effective as of the beginning of an entity's first fiscal year beginning after November 15, 2007. The Company is currently evaluating the impact of the adoption of SFAS No. 159.

In June 2007, the FASB ratified Emerging Issues Task Force ("EITF") No. 07-3, "Accounting for Non Refundable Advance Payments for Goods or Services Received for Use in Future Research and Development Activities" ("EITF 07-3"). EITF 07-3 requires that nonrefundable advance payments for goods or services that will be used or rendered for future research and development activities be deferred and capitalized and recognized as an expense as the goods are delivered or the related services are performed. EITF 07-3 is effective, on a prospective basis, for fiscal years beginning after December 15, 2007 and will be adopted in the first quarter of fiscal 2008. The Company is

currently evaluating the impact of the adoption of EITF 07-3 on its consolidated financial statements.

In December 2007, the FASB issued SFAS No. 141R, Business Combinations, or SFAS 141R. SFAS 141R establishes principles and requirements for how the acquirer of a business recognizes and measures in its financial statements the identifiable assets acquired, the liabilities assumed, and any non-controlling interest in the acquiree. The statement also provides guidance for recognizing and measuring the goodwill acquired in the business combination and determines what information to disclose to enable users of the financial statement to evaluate the nature and financial effects of the business combination. SFAS 141R is effective for financial statements issued for fiscal years beginning after December 15, 2008. Accordingly, any business combinations the Company executes will be recorded and disclosed following existing GAAP until January 1, 2009. The Company expects SFAS No. 141R will have an impact on its consolidated financial statements when effective, but the nature and magnitude of the specific effects will depend upon the nature, terms and size of the acquisitions it consummates after the effective date. The Company is still assessing the impact of this standard on its future consolidated financial statements.





NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES (CONT.)

In December 2007, the FASB issued SFAS No. 160, "Noncontrolling Interests in Consolidated Financial Statements - an amendment of ARB No. 51." SFAS No. 160 establishes accounting and reporting standards pertaining to ownership interests in subsidiaries held by parties other than the parent, the amount of net income attributable to the parent and to the noncontrolling interest, changes in a parent's ownership interest, and the valuation of any retained noncontrolling equity investment when a subsidiary is deconsolidated. This Statement also establishes disclosure requirements that clearly identify and distinguish between the interests of the parent and the interests of the noncontrolling owners. SFAS No. 160 is effective for fiscal years beginning on or after December 15, 2008. The Company is currently evaluating the impact that the adoption of FAS 160 would have on its consolidated financial statements.

In December 2007, the U.S. Securities and Exchange Commission ("SEC") issued Staff Accounting Bulletin 110 ("SAB No. 110") to amend the SEC's views discussed in Staff Accounting Bulletin 107 ("SAB No. 107") regarding the use of the simplified method in developing an estimate of expected life of share options in accordance with SFAS No. 123(R). SAB No. 110 is effective for the company beginning in the first quarter of fiscal year 2008. The Company does not expect the adoption of SAB No. 110 will have significant impact on its consolidated financial statement.

NOTE 3:- MARKETABLE SECURITIES

The following is a summary of the Company's investment in marketable securities:

| | DECEMBER 31, 2006 | | | | DE | | | |
|---|---|---|---|---|---|---|---|---|
| | AMORTIZED COST | GROSS UNREALIZED GAINS | GROSS UNREALIZED LOSSES | FAIR MARKET VALUE | AMORTIZED COST | GRO UNREA GAI |
| Available-for-sale: | | | | | | |
| Equity securities | $ 40 | $ 5 | $ (2) | $ 43 | $ 72 | $ |
| Corporate bonds | 45 | 1 | - | 46 | 16 | |
| Israeli Government debts | 63 | 7 | - | 70 | 68 | |
| | $ 148 | $ 13 | $ (2) | $ 159 | $ 156 | $ |

The gross realized gains on sales of available-for-sale securities totaled $ 77, $ 13 and $ 13 in 2005, 2006 and 2007, respectively, recorded in financial income. The net adjustment to unrealized holding gains (losses) on available-for-sale securities included as a separate component of shareholders' equity, "Accumulated other comprehensive gains (losses)" amounted to $ (76), $ 1 and $ 1 in 2005, 2006 and 2007, respectively.

None of the unrealized loss as of December 31, 2007, are outstanding over than 12 months period.





NOTE 3:- MARKETABLE SECURITIES (CONT.)

The amortized cost and fair value of debt and marketable equity securities as of December 31, 2007, by contractual maturity, are shown below.

| | DECEMBER 31, 2007 | |
|---|---|---|
| | AMORTIZED COST | FAIR MARKET VALUE |
| Matures after one year through five years | $ 68 | $ 80 |
| Matures after ten years | 16 | 16 |
| Equity securities - No definite | | |

| | | |
|---|---|---|
| maturity date | 72 | 73 |
| Total | $ 156 | $ 169 |

NOTE 4:- OTHER ACCOUNTS RECEIVABLE AND PREPAID EXPENSES

| | DECEMBER 31, | |
|---|---|---|
| | 2006 | 2007 |
| Grants receivable from the Office of the Chief Scientist | $ 454 | $ 335 |
| Government authorities | 77 | 17 |
| Prepaid expenses | 147 | 29 |
| Deferred income taxes (1) | 14 | 21 |
| Others (2) | 71 | 142 |
| | $ 763 | $ 544 |

(1) See Note 13d.
(2) See Note 5a.

NOTE 5:- INVESTMENTS IN OTHER COMPANIES

a. On December 10, 2007 the Company was notified that a privately-owned leading online advertising company, in which the Company hold approximately a 1% of its common shares, was sold to a third party for a total estimated consideration of $16,000 out of which the company proceeds' are approximately $36. The transaction was consummated on December 31, 2007 with the approval of the General Shareholders Meeting of this online advertising company and therefore was classified to other accounts receivable. Consequently the company recorded a capital loss in the amount of $63.

b. On January 31, 2008 the company consummated the sale of its ownership interest in Cvidya to a third party, in consideration of approximately $ 603. This consideration reflects a capital gain of $ 382. The Company recorded its investment in Cvidya as of December 31, 2007 in the amount of $ 221 in the current assets.





NOTE 6:- INVESTMENTS IN AFFILIATE

Composed as follows:

| | DECEMBER 31, |
|---|---|

| | 2006 | 2007 |
|---|---|---|
| Investment in Jusan S.A. (50% owned) | | |
| Equity, net (1) | $ 1,563 | $ - |
| Goodwill | 35 | - |
| | $ 1,598 | $ - |
| (1) Investment as of purchase date | $ 1,171 | $ - |
| Retained earnings (Net of dividends) | 392 | - |
| | $ 1,563 | $ - |
| Dividend received from Jusan S.A. during the year | $ 409 | $ 134 |

On November 29, 2007, the Company sold its 50% ownership interest in Jusan S.A., an affiliate, to the affiliate's other shareholders, in consideration of 700 Euros ($ 1,031) plus the payment of 25% of the net income of Jusan S.A. during the period commencing as of the date of the sale and ending June 30, 2008. This consideration reflects a loss of $ 197 recorded in equity in loss of affiliate.

NOTE 7:- OTHER INVESTMENTS

| | DECEMBER 31, | |
|---|---|---|
| | 2006 | 2007 |
| Long-term leasing deposits (1) | $ 46 | $ 3 |
| Investment in other companies (see also Note 5) | 320 | - |
| | $ 366 | $ 3 |

(1) Linked to the Israeli CPI.

NOTE 8:- PROPERTY AND EQUIPMENT

| | DECEMBER 31, | |
|---|---|---|
| | 2006 | 2007 |
| Cost: | | |
| Computers and peripheral equipment | $ 3,118 | $ 3,097 |
| Office furniture and equipment | 572 | 579 |
| Motor vehicles | 48 | 48 |
| Leasehold improvements | 150 | 93 |
| | 3,888 | 3,817 |
| Accumulated depreciation: | 3,449 | 3,534 |

| | | |
|---|---|---|
| Depreciated cost | $ 439 | $ 283 |

The depreciation expense for the years ended December 31, 2005, 2006 and 2007 amounted to $ 254, $ 243 and $ 251, respectively.





NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

U.S. DOLLARS IN THOUSANDS (EXCEPT SHARE AND PER SHARE DATA)

NOTE 9:- GOODWILL AND OTHER INTANGIBLE ASSETS

a. Goodwill:

The changes in the carrying amount of goodwill for the year ended December 31, 2006 and 2007 are as follows:

| | |
|---|---|
| Balance as of January 1, 2006 | $ 3,700 |
| Additional consideration in conjunction with TK acquisition based on post-contract billing revenues, see Note 1(c) | 192 |
| Goodwill acquired during the year (see Note 1d) | 166 |
| Balance as of December 31, 2006 | 4,058 |
| Additional consideration in conjunction with TK acquisition based on post-contract billing revenues, see Note 1(c) | 10 |
| Additional consideration based on post-contract Telecom Expense Management activity that was acquired from TelSoft (see Note 1d) | 606 |
| Impairment of goodwill related to billing activity that was acquired from Teleknowledge (1) | (1,878) |
| Balance as of December 31, 2007 | $ 2,796 |

(1) During 2007, the Company reviewed its goodwill for impairment and determined that there was an indication that the goodwill relating to the acquisition of the Teleknowledge billing activity had been impaired. The Company assessed the recoverable amount of such goodwill, based on its projections and using expected future discounted operating cashflows. Based on such review the Company determined that the goodwill relating to the acquisition of the Teleknowledge billing activity in the amount of $1,878 had been impaired and the carrying value was written-off.

b. Other intangibles consist of the following:

| | DECEMBER 31, | |
|---|---|---|
| | 2006 | 2007 |
| Cost: | | |
| Development technology | $ 1,873 | $ 1,183 |
| Capitalized software development costs | 386 | 386 |
| Customer relationship | 945 | 645 |
| | 3,204 | 2,214 |
| Accumulated amortization: | | |
| Development technology | 1,131 | 871 |
| Capitalized software development costs | 289 | 386 |
| Customer relationship | 145 | 152 |
| | 1,565 | 1,409 |
| Amortized cost | $ 1,639 | $ 805 |





NOTE 9:- GOODWILL AND OTHER INTANGIBLE ASSETS (CONT.)

Intangible assets resulted from acquisitions of IntegraTrak and TelSoft (see Note 1d), the Company's U.S. subsidiaries and TeleKnowledge (see Note 1c).

c. Amortization expenses amounted to $ 401, $ 432 and $ 401 for each of the years ended December 31, 2005, 2006 and 2007, respectively.

d. During 2007, the Company determined that intangible assets relating to the billing activity that was acquired from Teleknowledge had been impaired and as a result, recorded an impairment loss in the amount of $259 and $175 for developed technology and customer relationship, respectively.

e. Estimated amortization expenses for:

| YEAR ENDED DECEMBER 31, | |
|---|---|
| 2008 | $ 193 |
| 2009 | 193 |
| 2010 | 176 |

| | |
|---|---|
| 2011 | 152 |
| 2012 | 91 |
| | $ 805 |

NOTE 10:- ACCRUED EXPENSES AND OTHER LIABILITIES

| | DECEMBER 31, | |
|---|---|---|
| | 2006 | 2007 |
| Employees and payroll accruals | $ 949 | $ 919 |
| Income tax payable | 498 | 735 |
| Accrued expenses | 638 | 1,314 |
| Customer advances | 205 | 261 |
| Related parties | 217 | 80 |
| | $ 2,507 | $ 3,309 |

NOTE 11:- LONG-TERM BANK LOAN

a. Composed as follows:

| | DECEMBER 31, | |
|---|---|---|
| | 2006 | 2007 |
| Long-term loan | $ 1,000 | $ 583 |
| Less - current maturities | 417 | 583 |
| | $ 583 | $ - |

The loan bears annual interest at a rate of the monthly LIBOR + 2%, payable on a monthly basis on the outstanding loan amount commencing August 31, 2006. The loan principal is repaid in twelve equal monthly installments commencing August 31, 2007.





NOTE 11:- LONG-TERM BANK LOAN (CONT.)

b. The loan agreement includes the following covenants:

(i) The ratio between shareholders equity and total shareholders equity and liabilities shall not be less than 40% and in no event shall the Company's shareholders equity decrease below $ 5,000 thousand.

(ii) The Company will generate operating income for each of the two subsequent quarters commencing the second quarter of 2007 and onwards.

(iii) The Company's cash and cash equivalents shall not decrease below $ 1,000 at any given time.

In the event that the Company violates one of the above covenants the loan shall become immediately due. As of December 31, 2007 the Company is not in compliance with such covenants.

c. To secure the loan, the Company provided the Bank a floating charge on all its current and long term assets and a fixed charge on its goodwill and on its authorized but not outstanding shareholders equity.

NOTE 12:- COMMITMENTS AND CONTINGENT LIABILITIES

a. Lease commitments:

The facilities of the Company and its subsidiaries are rented under operating leases for periods ending May 2007 through June 2010.

Future minimum lease commitments under non-cancelable operating leases as of December 31, 2007 are as follows:

| | |
|---|---|
| 2008 | $ 455 |
| 2009 | 327 |
| 2010 | 150 |
| 2011 | - |
| | $ 932 |

Lease expenses for the years ended December 31, 2005, 2006 and 2007 were approximately $ 489, $ 479 and $ 544, respectively.





U.S. DOLLARS IN THOUSANDS (EXCEPT SHARE AND PER SHARE DATA)

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

b. Royalty commitments:

1. The Company is committed to pay royalties to the Office of the Chief Scientist of the Ministry of Trade ("OCS") of the Government of Israel on proceeds from sales of products resulting from the research and development projects in which the Government participated. In the event that development of a specific product in which the OCS participated is successful, the Company will be obligated to repay the grants through royalty payments at the rate of 3% to 5% based on the sales of the Company, up to 100%-150% of

the grants received linked to the dollar. As of December 31, 2007, the Company has a contingent liability to pay royalties in the amount of $ 9,842. The obligation to pay these royalties is contingent upon actual sales of the products and, in the absence of such sales, no payment is required.

The Company has paid or accrued royalties in its cost of revenues relating to the repayment of such grants in the amount of $ 198, $ 186 and $ 178 for the years ended December 31, 2005, 2006 and 2007, respectively.

2. The Israeli Government, through the Fund for Encouragement of Marketing Activities, awarded the Company grants for participation in foreign marketing expenses. The Company is committed to pay royalties at the rate of 3% of the increase in export sales, up to the amount of the grants received linked to the U.S. dollar. As of December 31, 2007, the Company has a contingent obligation to pay royalties in the amount of $ 259.

c. Claims and demands:

1. In April 2000, the Tax Authorities in Israel issued to the Company a demand for a tax payment, for the period of 1997-1999, in the amount of approximately NIS 6,000 thousand ($ 1,560).

The Company has appealed to the Israeli Tel Aviv district court in respect of the abovementioned tax demand. The Company believes that certain defenses can be raised against the demand of the tax authorities. The Company has provided a provision in the amount considered probable.

2. On April 18, 2005, Amdocs (Israel) Ltd. and Amdocs Ltd. ("the plaintiffs") filed a complaint with the Tel-Aviv District Court against the Company, its Chief Executive Officer and others ("the Defendants") alleging, among other things, that professional and commercial information belonging to the plaintiffs was transferred to the defendants for use in the Company's activity. The plaintiffs was seeking an injunction prohibiting the defendants from making any use of the information and trade secrets that were allegedly transferred, injunctions requiring the return of such information and estimated damages of NIS 14,775 thousand (approximately $ 3,500).

On March 22, 2007, the complaint had been dismissed without prejudice by mutual agreement and following a settlement between all parties to the complaint and with no payment by any of the litigants.

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

3. On November 22, 2005, the Company received a letter from one of its customer's legal counsel alleging, among other things, that the Company materially breached the agreement that was entered into with the customer who is seeking full repayment of the amounts that were paid by him under the agreement, including interest and indemnification for damages. The Company cannot currently assess the outcome of this claim or its adverse effect on the Company's financial position or results of operations.

4. On July 24, 2006, a claim was filed in the Tel-Aviv Superior Court against the company and Tim Computers and Systems Ltd, or TIM, for an order of inspection and monetary relief in the total amount of NIS 313 thousand ($82 thousand), of which NIS 112 thousand ($30 thousand) is demanded from the company and NIS 200 thousand ($52 thousand) is demanded from TIM. The plaintiff is a former minority shareholder of a company in which we were the major shareholder. The claim relates to the rights to proceeds received under a software development project in which TIM and the company participated and in which the plaintiff was involved. A preliminary hearing was held on Jan. 15, 2007. Due to the preliminary stage of this litigation, the company and its legal advisors cannot currently assess the outcome or possible adverse effect on the company's financial position or results of operations.

5. On February 21, 2007, one of the Company's suppliers ("the plaintiffs") filed a complaint with the Kfar-Saba Magistrate Court against the Company, in which he demands payment of NIS 179 thousand (approximately $ 47) with respect to electronic components that were ordered by the Company. The Company made a provision in its financial statements for this claimed amount. The abovementioned claim is related to the claim raised in Note 12c(3).

6. On March 15, 2007, The Company received a letter from one of its customer's legal counsel alleging, among other things, that the Company materially breached an agreement relating to its billing solutions that the Company entered into with the customer on March 30, 2006. The customer is seeking full repayment of the amounts that were paid by him under the agreement in the amount of approximately $141, plus liquidated damages as provided in the agreement. Due to the preliminary stage of this matter, the Company cannot currently assess the outcome or possible adverse effect on its financial position or results of operations.

7. During August 2007, TABS Brazil, was ordered by the Labor Law Court in Brazil to pay approximately 180 Brazilian Reais (approximately $101) to one of its former employees. TABS Brazil has filed an appeal against the Labor Law Court ruling. The Company recorded a provision in its financial statements for the amount of the award considered probable.

d. Guarantees:

The Company provided a bank guarantee through September 2010 in the amount of $ 190 to secure its obligations under one of its leasing agreements.

NOTE 13:- TAXES ON INCOME

a. ISRAELI TAXATION:

1. CORPORATE TAX STRUCTURE:

Taxable income of Israeli companies is subject to tax at the rate of 31% in 2006, 29% in 2007, 27% in 2008, 26% in 2009 and 25% in 2010 and thereafter.

2. Tax benefits under the Law for the Encouragement of Capital Investments, 1959 ("the Law"):

The Investment Law empowers the Israeli Investment Center to grant Approved Enterprise status to capital investments in production facilities that meet certain relevant criteria ("Approved Enterprise"). In general, such capital investments will receive Approved Enterprise status if the enterprise is expected to contribute to the development of the productive capacity of the economy, absorption of immigrants, creation of employment opportunities, or improvement in the balance of payments.

The tax benefits derived from any such Approved Enterprise relate only to taxable income attributable to the specific program of investment to which the status was granted. Since MTS is operating more than one "Approved Enterprise" program and since part of its taxable income is not entitled to tax benefits under the abovementioned law and is taxed at the regular corporate tax rate, its effective tax rate is the result of a weighted combination of the various applicable rate and tax exemptions, and the computation is made for income derived from each program on the basis of formulas specified in the law and in the approvals.

MTS was granted the status of an "Approved Enterprise" under the Law in respect of several different capital expenditure programs. For all of such Approved Enterprises, the Company elected to apply for alternative tax benefits ("Alternative Package").

Accordingly, MTS Ltd.'s income attributed to the Approved Enterprise under the alternative package is tax exempt for a period of two years, commencing with the year the Company earns taxable income, and subject to corporate tax at the rate of 10%-25% (depending on the rate of foreign holdings in the Company), for additional periods of five to eight years.

In the event of distribution of dividends from the said tax-exempt income, the amount distributed will be subject to

corporate tax at the rate ordinarily applicable to the Approved Enterprise's income.

The duration of tax benefits, for each of the Programs is subject to limitations of the earlier of 12 years from completion of the investment or commencement of production, or 14 years from receipt of approval, as an Approved Enterprise under the Law.

The entitlement to the above benefits is conditional upon the Company's fulfilling the conditions stipulated by the Law and regulations published thereunder.





NOTE 13:- TAXES ON INCOME (CONT.)

Should MTS Ltd. fail to meet such requirements in the future, income attributable to its Approved Enterprise programs could be subject to the statutory Israeli corporate tax rate and the Company could be required to refund a portion of the tax benefits already received, with respect to such programs.

On April 1, 2005, an amendment to the Investment Law came into effect ("the Amendment") and has significantly changed the provisions of the Investment Law. The Amendment limits the scope of enterprises which may be approved by the Investment Center by setting criteria for the approval of a facility as a "Privileged Enterprise" (rather than the previous terminology of Approved Enterprise), such as a provision requiring that at least 25% of the "Privileged Enterprise's" income will be derived from export. Additionally, the Amendment enacted major changes in the manner in which tax benefits are awarded under the Investment Law so that companies are no longer required for Investment Center approval in order to qualify for tax benefits. The period of tax benefits for a new "Privileged Enterprise" commences in the "Year of Commencement". This year is the later of: (1) the year in which taxable income is first generated by the company, or (2) the Year of Election.

If a company requested the "Alternative Package" of benefits for an Approved Enterprise under the old law before the 2005 amendment, it is precluded from filing a Year of Election notice for a "Privileged Enterprise" for three years after the year in which the Approved Enterprise was activated.

In addition, the Investment Law provides that terms and benefits included in any certificate of approval already granted will remain subject to the provisions of the law as they were on the date of such approval. Therefore, the existing Approved Enterprises will not be subject to the

provisions of the Amendment.

As a result of the amendment, tax-exempt income generated under the provisions of the amended law, will subject the Company to taxes upon dividend distribution or complete liquidation.

Dividend distributed by an Approved Enterprise and "Privileged Enterprise" will be subject to withholding tax of 15%.

Out of the Company's retained earnings as of December 31, 2007 approximately $2,250 are tax exempt attributable to its Approved Enterprise programs. If such tax exempt income is distributed in a manner other than upon the complete liquidation of the Company, it would be taxed at the reduced corporate tax rate applicable to such profits (between 10%-25%) and an income tax liability of up to approximately $ 562 would be incurred as of December 31, 2007.

The Company's board of directors has determined that it would not distribute any amounts of its undistributed tax exempt income as dividend. The Company intends to reinvest the amount of its tax exempt income. Accordingly, no deferred income taxes have been provided on income attributable to the Company's "Approved Enterprise" as the undistributed tax exempt income is essentially permanent in duration.

Income from sources other than the Approved Enterprise is subject to tax at regular Israeli corporate tax rate.





NOTE 13:- TAXES ON INCOME (CONT.)

3. Tax assessments:

Regarding the claim from the tax authorities in Israel, see Note 12c(1). The Company has received final tax assessments until the 1996 tax year.

4. Measurement of results for tax purposes under the Income Tax (Inflationary Adjustments) Law, 1985:

Results for tax purposes are measured in terms of earnings in NIS after certain adjustments for increases in the Israeli Consumer Price Index ("CPI"). As explained in Note 2b, the financial statements are presented in dollars. The difference between the annual change in the CPI and in the NIS/dollar exchange rate causes a further difference between taxable income and the income before taxes presented in the financial statements. In accordance with paragraph 9(f) of SFAS 109, MTS and its Israeli subsidiary have not provided

for deferred income taxes on the difference between the functional currency and the tax bases of assets and liabilities.

5. Tax benefits under the Law for the Encouragement of Industry (Taxation), 1969:

MTS is currently qualified as an "industrial company" under the above law and, as such, is entitled to certain tax benefits, mainly accelerated depreciation of machinery and equipment, as prescribed by regulations published under the Inflationary Adjustments Law, the right to claim public issuance expenses and amortization of intangible property rights as a deduction for tax purposes.

b. Income taxes on non-Israeli subsidiaries:

Non Israeli subsidiaries are taxed according to the tax laws in their respective country of residence.

c. Net operating losses carryforward:

As of December 31, 2007, the Company and its subsidiaries in Israel, Hong Kong and U.S. have an estimated total amount of available carryforward tax losses of $ 15,151, $ 261 and $ 503, respectively to offset against future taxable profits. The operating tax loss carryforwards in Israel and in Hong Kong may be offset indefinitely against operating income.

MTS IntegraTrak and MTS TelSoft are subject to U.S. income taxes and have a net operating loss carryforward amounting to approximately $ 503 as of December 31, 2007, which expires in the years 2015 to 2022. Utilization of the U.S. net operating losses may be subject to substantial annual limitation due to the "change in ownership" provisions of the Internal Revenue Code of 1986 and similar state provisions. The annual limitation may result in the expiration of net operating losses before utilization.





U.S. DOLLARS IN THOUSANDS (EXCEPT SHARE AND PER SHARE DATA)

NOTE 13:- TAXES ON INCOME (CONT.)

d. Deferred income taxes:

Deferred 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 tax liabilities and assets are as follows:

DECEMBER 31,

| | 2006 | 2007 |
|---|---|---|
| Tax loss carryforward of the Company | $ 2,416 | $ 3,292 |
| Allowances for doubtful accounts and accruals for employee benefits | 69 | 205 |
| In respect of marketable securities | 47 | 47 |
| Goodwill and other intangible assets-liability | (253) | (227) |
| Capitalized software and other intangible assets | 304 | 869 |
| Other | 442 | 249 |
| Net deferred tax asset before valuation allowance | 3,025 | 4,435 |
| Valuation allowance | (2,899) | (4,291) |
| Net deferred income taxes | $ 126 | $ 144 |
| Presented as follows: | | |
| Current assets - foreign | $ 14 | $ 21 |
| Other assets - foreign | $ 112 | $ 123 |

MTS and certain of its subsidiaries have provided valuation allowances in respect of deferred tax assets resulting from tax loss carryforward and other temporary differences, since they have a history of losses over the past years. Management currently believes that it is more likely than not that part of the deferred tax regarding the loss carryforward in the Company and other temporary differences will not be realized in the foreseeable future.





NOTE 13:- TAXES ON INCOME (CONT.)

e. A reconciliation between the theoretical tax expense, assuming all income is taxed at the statutory tax rate applicable to income of the Company and the actual tax expense as reported in the statements of operations, is as follows:

| | YEAR ENDED DECEMBER 31, | | |
|---|---|---|---|
| | 2005 | 2006 | 2007 |
| Loss before taxes as reported in the | | | |

| | | | |
|---|---|---|---|
| statements of operations | $ (4,208) | $ (2,287) | $ (5,6 |
| Tax rates | 34% | 31% | |
| Theoretical tax benefit | $ (1,431) | $ (709) | $ (1,6 |
| Increase in taxes resulting from: | | | |
| Effect of different tax rates | 38 | (17) | ( |
| Tax adjustment in respect of inflation in Israel and others | (17) | (9) | 2 |
| Utilization of carryforward tax losses for which valuation allowance was provided | - | (22) | ( |
| Non-deductible expenses and tax exempt income | 10 | 13 | |
| Taxes and deferred taxes in respect of previous years | (21) | 112 | ( |
| Deferred taxes for which valuation allowance was provided | 1,431 | 750 | 1,3 |
| Taxes on income (benefit), net, as reported in the statements of operations | $ 10 | $ 118 | $ ( |

f. Loss before income taxes is comprised as follows:

| | | | |
|---|---|---|---|
| Domestic | $ (4,042) | $ (1,511) | $ (5,4 |
| Foreign | (166) | (776) | (1 |
| | $ (4,208) | $ (2,287) | $ (5,6 |





NOTE 13:- TAXES ON INCOME (CONT.)

g. Taxes on income are comprised as follows:

| | YEAR ENDED DECEMBER 31, | | |
|---|---|---|---|
| | 2005 | 2006 | 2007 |
| Current taxes | $ - | $ 5 | $ |
| Deferred taxes | 10 | 3 | |
| Taxes and deferred taxes in respect of | | | |

| | | | |
|---|---|---|---|
| previous years | - | 110 | ( |
| | $ 10 | $ 118 | $ ( |
| Domestic | $ - | $ - | $ |
| Foreign | 10 | 118 | ( |
| | $ 10 | $ 118 | $ ( |

h. The Company adopted the provisions of FIN 48 on January 1, 2007. As of January 1, 2007 there was no difference between the provisions of SFAS 109 and FIN 48 therefore no adjustment was recorded to the retained earnings.

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

| | |
|---|---|
| Gross unrecognized tax benefits as of January 1, 2007 | $ 583 |
| Gross unrecognized tax benefits as of December 31, 2007 | $ 583 |

The Company conducts business globally and, as a result, MTS or one or more of its subsidiaries file income tax returns in the U.S. federal jurisdiction and various state 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 and the United States. With few exceptions, the Company is no longer subject to Israeli income tax examinations for years 2002 and 2001.

The Company has not accrued any penalties or interest payments related to its uncertain tax positions as the Company believes that it is more likely than not that there will not be any assessment of penalties or interest.

NOTE 14:- RELATED PARTIES TRANSACTIONS AND BALANCES

a. On November 8, 1999, the Board of Directors and the audit committee approved, subject to the shareholders' approval, an increase in the monthly salary of the Chairman of the Board of Directors from $ 5 to $ 7 per month.

The wife of the Chairman of the Board of Directors provides ongoing legal services to the Company and receives a monthly retainer of $ 5. The conditions for retaining her services were approved by the Company's Board of Directors and audit committee.

U.S. DOLLARS IN THOUSANDS (EXCEPT SHARE AND PER SHARE DATA)

NOTE 14:- RELATED PARTIES TRANSACTIONS AND BALANCES (CONT.)

MTS's subsidiaries, MTS Asia Ltd. and MTS IntegraTRAK, entered into an agreement with C. Mer, pursuant to which they distribute and support certain of C. Mer's (company under common control) products and provide certain services on behalf of C. Mer. Generally, C. Mer compensates MTS Asia Ltd. for these activities at cost plus 10% and compensates MTS IntegraTRAK at cost plus 5%.

b. In 2006 and 2007, the balance with C. Mer reflects other receivables and other payables. Due to the short-term nature, no interest was charged by or paid to C. Mer through December 31, 2006 and 2007.

c. Transactions with related parties were as follows:

| | YEAR ENDED DECEMBER 31, | | |
|---|---|---|---|
| | 2005 | 2006 | 2007 |
| Sales through related parties | $ - | $ - | $ |
| Amounts charged by related parties: | | | |
| Cost of revenues | $ 8 | $ 10 | $ |
| Operating expenses | 42 | 60 | |
| | $ 50 | $ 70 | $ |
| Amounts charged by MTS IntegraTRAK and MTS Asia to related parties: | | | |
| Selling and marketing | $ - | $ 246 | $ |
| Payments from (repayments to) the related parties, net | $ (80) | $ (38) | $ 1 |

NOTE 15:- SHAREHOLDERS' EQUITY

a. Share capital:

The Ordinary shares entitle their holders the right to receive notice to participate and vote in general meetings of MTS and the right to receive cash dividends, if declared.

b. Private placement agreements:

On August 10, 2005, the Company has entered into definitive agreements with institutional and private investors for a private placement of Ordinary shares and warrants to purchase Ordinary shares that has raised $ 2,625 (net of issuance costs of

approximately $ 200).





NOTE 15:- SHAREHOLDERS' EQUITY (CONT.)

Pursuant to the agreements, MTS has issued an aggregate 937,500 Ordinary shares at $ 3.00 per share. In addition, the Company provided the investors with warrants to purchase an aggregate 375,000 additional Ordinary shares of MTS at an exercise price of $ 4.00 per share. Each investor received warrants to purchase two Ordinary shares for each five Ordinary shares purchased. The warrants became exercisable six months after their issuance and will expire within three and a half years after they become exercisable.

On January 24, 2008, the Company and a private investor entered into a definitive agreement for a private placement of 750,000 ordinary shares at a price per share of $ 1 for the aggregate purchase price of $ 750.

c. Stock options:

MTS has authorized, through its 1996 Incentive Share Option plan, the grant of options to officers, management, employees and directors of MTS or any subsidiary of up to 1,900,000 of MTS's Ordinary shares. Up to 1,500,000 options shall be granted under the option plan pursuant to section 102 of the Israel Income Tax Ordinance. Any option, which is canceled or forfeited before expiration, will become available for future grants.

Each option granted under the Plan is exercisable until the earlier of five years from the date of the grant of the option or the expiration dates of the option plan. 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 were exercised. The options vest primarily gradually over three or four years of employment.

In 2003, Section 102 of the Israeli Income Tax Ordinance was amended effective as of January 1, 2003. Therefore MTS has rolled-over the remaining options available at that time to be granted under a new plan that conforms with the newly amended provisions of Section 102 of the Israel Income Tax Ordinance. The Incentive Share Option Plan will terminate in 2013, unless cancelled earlier by MTS's board of directors.

In June 2006, MTS has authorized, through its 2006 Stock Option plan ("2006 Plan"), the grant of options to officers, management, employees and directors of MTS or any subsidiary of up to 400,000 of MTS's Ordinary shares. Each option granted under the 2006 Plan will be either an option intended to be treated as an "incentive stock option," within the meaning of Section 422 of the Internal Revenue Code of 1986, as amended, or an option that will be

treated as a "non-qualified stock option."

Each option granted under the Plan is exercisable until the earlier of five years from the date of the grant of the option or the expiration dates of the option plan. The exercise price of the options granted under the plans may not be less than the fair market value of an ordinary share determined as of the date of grant of the option.

As of December 31, 2007, 659,374 options are available for future grant.





NOTE 15:- SHAREHOLDERS' EQUITY (CONT.)

d. A summary of option activity under the Company's Stock Option as of December 31, 2007 and changes during the twelve months ended December 31, 2007 are as follows:

| | NUMBER OF OPTIONS | WEIGHTED-AVERAGE EXERCISE PRICE | WEIGHTED-AVERAGE REMAINING CONTRACTUAL TERM (IN YEARS) | AGGREGATE INTRINSIC VALUE |
|---|---|---|---|---|
| | AUDITED | | | |
| Outstanding at December 31, 2006 | 600,400 | $ 2.67 | 2.79 | $ - |
| Granted | 110,000 | $ 1.23 | - | - |
| Exercised | - | - | - | - |
| Forfeited | (33,800) | $ 3.15 | - | - |
| Outstanding at December 31, 2007 | 676,600 | $ 2.41 | 2.27 | $ - |
| Exercisable at December 31, 2007 | 415,725 | $ 2.36 | 1.45 | $ - |
| Vested and expected to vest | 616,768 | $ 2.39 | 2.23 | $ - |

The weighted average grant-date fair value of options granted during 2005, 2006 and 2007, was $ 1.70, $ 1.94 and $ 0.50 per option, respectively.

The total compensation cost related to options granted to employees under the Company's share-based compensation plans recognized for the year ended December 31, 2006 and 2007 amounted

at $ 210 and $ 92 respectively, net of estimated forfeitures.

The aggregate intrinsic value in the table above represents the total intrinsic value (the difference between the Company's closing stock price on the last trading day of the fiscal year 2007 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, 2007. This amount changes based on the fair market value of the Company's stock. The total intrinsic value of options exercised during the years ended December 31, 2007, 2006, and 2005, was $ 0, $ 55 and $ 188, respectively. As of December 31, 2007, there was $ 131 of total unrecognized compensation cost related to non-vested share-based compensation arrangements granted under the Company's stock option plans. That cost is expected to be recognized over a weighted-average period of 3 years.

e. Options and warrants to non-employees:

| ISSUANCE DATE | IN CONNECTION WITH | NUMBER OF OPTIONS GRANTED | OPTIONS EXERCISED | OPTIONS EXERCISABLE | OPTIONS FORFEITED OR EXPIRED | EXERCISE PRICE PER SHARE |
|---|---|---|---|---|---|---|
| January 2005 | Service provider | 70,000 | - | 70,000 | - | $ 3.250 |
| August 2005 | Service provider | 37,000 | - | 37,000 | - | $ 4.000 |
| | | 107,000 | - | 107,000 | - | |





NOTE 15:- SHAREHOLDERS' EQUITY (CONT.)

During 2007, no options to consultants were granted by the Company. The Company had accounted for its outstanding options to non-employees under the fair value method of SFAS No. 123 and EITF 96-18. The fair value for these options was estimated at the measurement date using the Black-Scholes option-pricing model with the following weighted-average assumptions for 2005: risk-free interest rates of 4.06%, dividend yields of 0%, volatility factors of the expected market price of the Company's Ordinary shares of 52.37%, and a contractual life of 3.3 years.

Compensation expenses related to the granting of stock options to consultants amounted to $ 156, $ 10 and $ 0 for the years ended December 31, 2005, 2006 and 2007, respectively.

f. Treasury shares:

During 2005, 2006 and 2007, the Company purchased 3,800, 0 and 0 treasury shares in consideration of $ 9 $ 0 and $ 0, respectively, according to the stock repurchase program, which authorized the Company's officers to repurchase up to 600,000 Ordinary shares of MTS and was approved by the Company's Board of Directors.

g. Dividends:

Dividends, if any, will be paid in NIS. Dividends paid to shareholders outside Israel will be converted into dollars, on the basis of the exchange rate prevailing at the date of payment.

NOTE 16:- GEOGAPHIC INFORMATION AND MAJOR CUSTOMERS AND PRODUCTS

The Company adopted Statement of Financial Accounting Standard No. 131, "Disclosures About Segments of an Enterprise and Related Information" ("SFAS No. 131"). The Company operates in one reportable segment (see Note 1 for a brief description of the Company's business). The total revenues are attributed to geographic areas based on the location of the customer.

The following is a summary of revenues within geographic areas based on end customer location and long-lived assets:

| | YEAR ENDED DECEMBER 31, | | |
|---|---|---|---|
| | 2005 | 2006 | 2007 |
| Revenues from sales: | | | |
| United States | $ 6,043 | $ 5,353 | $ 4,919 |
| Germany | 2,059 | 1,881 | 1,402 |
| Asia | 359 | 624 | 565 |
| Holland | 747 | 561 | 488 |
| Others | 2,355 | 2,065 | 1,964 |
| | $ 11,563 | $ 10,484 | $ 9,338 |





NOTE 16:- GEOGAPHIC INFORMATION AND MAJOR CUSTOMERS AND PRODUCTS (CONT.)

Total revenues from external customers divided on the basis of the Company's product lines are as follows:

| | DECEMBER 31, | | |
|---|---|---|---|
| | 2005 | 2006 | 2007 |
| TABS | $ 7,454 | $ 5,329 | $ 5,650 |
| Application suits | 2,603 | 4,044 | 3,102 |

| | | | |
|---|---|---|---|
| Billing products | 1,506 | 1,111 | 586 |
| | $ 11,563 | $ 10,484 | $ 9,338 |
| Long-lived assets: | | | |
| Israel | $ 3,013 | $ 3,177 | $ 481 |
| United States | 2,194 | 2,913 | 3,368 |
| Others | 57 | 46 | 35 |
| | $ 5,264 | $ 6,136 | $ 3,884 |

NOTE 17:- SUBSIDIARIES AND AFFILIATES

| | PERCENTAGE OF OWNERSHIP | JURISDICTI INCORPORA |
|---|---|---|
| SUBSIDIARIES: | | |
| MTS IntegraTRAK Inc. | 100% | Delawa |
| MTS TelSoft Inc. (a subsidiary of MTS IntegraTRAK Inc.) | 100% | Delawa |
| MER Fifth Avenue Realty Inc. (a subsidiary of MTS IntegraTRAK Inc.) (*) | 100% | New Yo |
| MTS Asia Ltd. | 100% | Hong Ko |
| Telegent Ltd. (*) | 100% | Israe |
| Jaraga B.V. | 100% | Netherla |
| Verdura B.V. (a subsidiary of Jaraga B.V.) (*) | 100% | Netherla |
| Voltera Technologies V.O.F. (a partnership held 99% by Jaraga B.V. and 1% by Verdura B.V.) (*) | 100% | Netherla |
| Bohera B.V. (a subsidiary of Jaraga B.V.) (*) | 100% | Netherla |
| Tabs Brazil Ltd. (a subsidiary of Bohera B.V.) | 100% | Brazi |

(*) Inactive, or having immaterial activity.





NOTE 18:- SUBSEQUENT EVENTS

a. On January 24, 2008, the Company and a private investor entered into a definitive agreement for a private placement of 750,000 ordinary shares at a price per share of $ 1 for the aggregate purchase price of $ 750.

b. On February 4, 2008 the company consummated the sale of its ownership interest in Cvidya to a third party, in consideration of approximately $ 603. This consideration reflects a capital gain of $ 382.

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JUSAN, S.A.

FINANCIAL STATEMENTS

AS OF DECEMBER 31, 2006 AND 2005

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REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

Board of Directors and Stockholders of JUSAN, S.A.

1. We have audited the accompanying balance sheets of JUSAN, S.A. ("the Company") as of December 31, 2006 and the related statements of income, shareholders' equity and cash flows for each of the two years in the period ended December 31, 2006. 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.

2. 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 the financial statements are free of material misstatement. The Company is not required to have, nor were we engaged to perform, an audit of its internal control over financial reporting. Our audits included consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, 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.

3. In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of JUSAN, S.A. as of

December 31, 2006 and the results of its operations and its cash flows for each of the two years in the period ended December 31, 2006 in conformity with accounting principles generally accepted in the United States of America.

BDO AUDIBERIA AUDITORES, S.L.

/s/ BDO Audiberia

Madrid, Spain, January, 19, 2007



JUSAN, S.A.
BALANCE SHEETS AS OF DECEMBER 31, 2006
EUROS IN THOUSANDS

| | DECEMBER 31, 2006 |
|---|---|
| ASSETS | |
| CURRENT ASSETS: | |
| Cash and cash equivalents | 236 |
| Short-term bank deposits | 867 |
| Trade receivables (net of allowance for doubtful accounts of - thousand euros as of December 31, 2006 and 57 thousand euros as of December 31, 2005 and net of provision for returns of 4 thousand euros as of December 31, 2006 and 4 thousand euros as of December 31, 2005) (Note 5) | 1,098 |
| Other accounts receivable and prepaid expenses (Note 3) | 138 |
| Inventories (Note 4) | 503 |
| Total current assets | 2,842 |
| PROPERTY AND EQUIPMENT, NET (Note 6) | 67 |
| Total assets | 2,909 |
| LIABILITIES AND SHAREHOLDERS' EQUITY | |
| CURRENT LIABILITIES: | |
| Short-term bank debt (Note 7) | 17 |
| Trade payables | 324 |
| Accrued expenses and other liabilities (Note 8) | 176 |
| Deferred revenues | 10 |
| Total current liabilities | 527 |
| COMMITMENTS (Note 9) | |

| | |
|---|---|
| SHAREHOLDERS' EQUITY (Note 12): | |
| Share capital - | |
| 15,052 Ordinary shares of (euro) 0.0042 par value - Authorized, issued and outstanding as of December 31, 2006 and 2005 | 63 |
| Retained earnings | 2,319 |
| Total shareholders' equity | 2,382 |
| Total liabilities and shareholders' equity | 2,909 |

The accompanying notes are an integral part of the financial statements

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JUSAN, S.A.

STATEMENTS OF INCOME AS OF DECEMBER 31, 2006 AND 2005
EUROS IN THOUSANDS (EXCEPT SHARE AND PER SHARE DATA)

| | YEAR ENDED DECEMBER 31, 2006 | 2005 |
|---|---|---|
| Revenues (Note 13): | | |
| Product sales | 3,833 | 3,935 |
| Services | 520 | 632 |
| Total revenues | 4,353 | 4,567 |
| Cost of revenues: | | |
| Product sales | 1,812 | 2,098 |
| Services | 423 | 435 |
| Total cost of revenues | 2,235 | 2,533 |
| Gross profit | 2,118 | 2,034 |
| Operating expenses: | | |
| Research and development | 456 | 449 |
| Selling and marketing | 746 | 849 |
| General and administrative | 667 | 831 |
| Total operating expenses | 1,869 | 2,129 |
| Operating income / (loss) | 249 | (95) |

| | | |
|---|---|---|
| Financial income, net (Note 14) | 6 | 20 |
| Income before taxes on income | 255 | (75) |
| Income taxes (Note 10) | 59 | (55) |
| Net income / (loss) | 196 | (20) |
| Basic and diluted net earnings per share | 13.02 | (1.33) |
| Weighted average number of shares used in computing basic net earnings per share | 15,052 | 15,052 |

The accompanying notes are an integral part of the financial statements



JUSAN, S.A.

STATEMENTS OF CHANGES IN SHAREHOLDERS' EQUITY
AS OF DECEMBER 31, 2006 AND 2005
EUROS IN THOUSANDS

| | SHARE CAPITAL | RETAINED EARNINGS | TOTAL SHAREHOLDERS' EQUITY |
|---|---|---|---|
| Balance as of December 31, 2004 | 63 | 3,083 | 3,146 |
| Dividend paid | - | (300) | (300) |
| Net income | - | (20) | (20) |
| Balance as of December 31, 2005 | 63 | 2,763 | 2,826 |
| Dividend paid | - | (640) | (640) |
| Net income | - | 196 | 196 |
| Balance as of December 31, 2006 | 63 | 2,319 | 2,382 |

The accompanying notes are an integral part of the financial statements



JUSAN, S.A.
STATEMENTS OF CASH FLOWS AS OF DECEMBER 31, 2006 AND 2005
EUROS IN THOUSANDS

| | YEAR ENDED DECEMBER 31, 2006 | 2005 |
|---|---|---|
| CASH FLOWS FROM OPERATING ACTIVITIES: | | |
| Net income | 196 | (20) |
| Adjustments to reconcile net income to net cash provided by (used in) operating activities: | | |
| Depreciation | 29 | 38 |
| Deferred taxes | 2 | (30) |
| Decrease (increase) in trade receivables | 600 | 367 |
| Decrease (increase) in other accounts receivable and prepaid expenses | 22 | 12 |
| Decrease (increase) in inventories | 168 | 241 |
| Increase (decrease) in trade payables | (158) | (177) |
| Increase (decrease) in accrued expenses and other liabilities | (165) | 14 |
| Increase (decrease) in deferred revenues | (39) | (11) |
| Net cash (provided by) operating activities | 655 | 434 |
| CASH FLOWS FROM INVESTING ACTIVITIES: | | |
| Investment in short-term bank deposits | (467) | 50 |
| Purchase of property and equipment | (58) | (26) |
| Net cash provided by (used in) investing activities | (525) | 24 |
| CASH FLOWS FROM FINANCING ACTIVITIES: | | |
| Dividend paid | (640) | (300) |
| Short-term bank debt | 9 | (10) |
| Net cash used in financing activities | (631) | (310) |
| Increase (decrease) in cash and cash equivalents | (501) | 148 |
| Cash and cash equivalents at the beginning of the year | 737 | 589 |
| Cash and cash equivalents at the end of the year | 236 | 737 |
| NON-CASH FINANCING INFORMATION: | | |
| Accrued dividend | - | - |
| SUPPLEMENTAL DISCLOSURE OF CASH FLOWS ACTIVITIES: | | |
| Cash paid during the year for: | | |
| Interest | 6 | 20 |
| Income taxes | - | - |

The accompanying notes are an integral part of the financial statements

NOTE 1: ORGANIZATION AND OPERATIONS

a. JUSAN, S.A. ("the Company") was incorporated in Spain on June 19, 1959. The Company is engaged on development, manufacturing and assembly, sales and distribution, and maintenance of vocal server and call billing applications, as well as is in the television rental business.

b. The Company has five major customers (see also Note 13a).

c. In accordance with Spanish Companies' Law the directors present, for comparative purposes, each of the balance sheet and profit and loss account, the figures for the previous financial years, in addition to those for the financial year 2006.

NOTE 2: SIGNIFICANT ACCOUNTING POLICIES

The financial statements have been prepared in accordance with generally accepted accounting principles in the United States ("US GAAP").

a. Use of estimates:

The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the amounts reported in the financial statements and accompanying notes. Actual results could differ from those estimates.

b. Financial statements in euros

Monetary accounts maintained in currencies other than the Euro are remeasured into Euros in accordance with Statement of Financial Accounting Standard No. 52, "Foreign Currency Translation" ("SFAS No. 52"). All effects of foreign currency remeasurement of monetary balance sheet items are reflected in the statements of operations as financial income or expenses, as appropriate.

c. Cash equivalents:

The Company considers all highly liquid investments originally purchased with maturities of three months or less to be cash equivalents.

There are no restrictions for cash and cash equivalents.



d. 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 Euro and bear interest at an average rate of 3%. The short-term deposits are presented at their cost, including accrued interest.

e. Inventories:

Inventories are stated at the lower of cost or market value. Cost is determined as follows: Raw materials, parts and supplies -using the weighted average cost method. Work in progress and finished products are recorded on the basis of direct manufacturing costs. Inventories write-offs are provided to cover risks arising from slow moving items or technological obsolescence.

f. Property and equipment:

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

| | % |
|---|---|
| Computers and peripheral equipment | 33 |
| Office furniture and equipment | 20 |
| Motor vehicles | 20 |

The Company's long-lived assets are reviewed for impairment in accordance with Statement of Financial Accounting Standard No. 144 "Accounting for the Impairment or Disposal of Long- Lived Assets" ("SFAS No. 144") whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. Recoverability of assets to be held and used is measured by a comparison of the carrying amount of an asset 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.

g. Research and development costs:

Research and development costs are charged to the Statement of Operations as incurred. Statement of Financial Accounting Standard No. 86 "Accounting for the Costs of Computer Software to be Sold, Leased or Otherwise Marketed" ("SFAS No. 86"), requires capitalization of certain software development costs subsequent to the establishment of technological feasibility.

Based on the Company's product development process, technological feasibility is established upon completion of a working model. Costs incurred by the Company between completion of the working models and the point at which the products are ready for general release have been insignificant. Therefore, all research and development costs have been expensed.



h. Income taxes:

The Company accounts for income taxes in accordance with Statement of Financial Accounting Standard No. 109, "Accounting for Income Taxes" ("SFAS No. 109"). This statement prescribes the use of the liability method whereby deferred tax assets and liability account balances are determined based on differences between financial reporting and tax bases of assets and liabilities and are measured using the enacted tax rates and laws that will be in effect when the differences are expected to reverse. Valuation allowances are provided to reduce deferred tax assets to an amount whose realization is considered more likely than not.

i. Revenue recognition:

The Company generates revenues from selling software-based products through resellers and distributors who are considered end-users. The Company also generates revenues from rendering maintenance and support services.

Revenues are recognized when all criteria outlined in Statement of Position No. 97-2 "Software Revenue Recognition" ("SOP No. 97-2") as amended are met. Revenue from products is recognized when persuasive evidence of an agreement exists, delivery of the product has occurred, no significant obligations with regard to

implementation remain, the fee is fixed or determinable and collectibility is probable.

Where the arrangements involve multiple elements, revenue is allocated to each element based on vendor specific objective evidence ("VSOE") of the relative fair values of each element in the arrangement, in accordance with the "residual method" prescribed by SOP No. 98-9, "Modification of SOP No. 97-2, Software Revenue Recognition With Respect to Certain Transactions". The VSOE used by the Company to allocate the sales price to support services and maintenance is based on the renewal rate charged when these elements are sold separately. Revenues from products are recorded based on the residual method. Under the residual method, revenue is recognized for the delivered elements when (1) there is VSOE of the fair values of all the undelivered elements, and (2) all revenue recognition criteria of SOP No. 97-2, as amended, are satisfied. Under the residual method any discount in the arrangement is allocated to the delivered element.

Provision for returns in the amount of thousand (euro) 3 is determined principally on the basis of past experience.

Revenues from maintenance and support services are recognized over the life of the maintenance agreement or at the time support services are rendered.



Deferred revenues include unearned amounts received under maintenance and support contracts, not yet recognized as revenues.

j. Warranty costs:

The Company provides free warranty for up to one year. A provision in the amount of thousand (euro) 10 (thousand (euro) 20 in 2005) is recorded for probable costs in connection with these services based on the Company's experience.

The Company estimates the costs that may be incurred under its basic limited warranty 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.

k. Fair value of financial instruments:

The carrying amounts of cash and cash equivalents, short-term bank deposits, trade receivables, other accounts receivable and trade payables approximate their fair value, due to the short-term maturity of such instruments.

There are short term fixed-rate securities as an amount of thousand (euro) 867.

l. Concentrations of credit risk:

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

Cash and cash equivalents and short-term bank deposits are deposited with major banks in Spain. Management believes that the financial institutions that hold the Company's investments are financially sound, and accordingly, minimal credit risk exists with respect to these investments.

The trade receivables of the Company are mainly derived from sales to customers in Spain and Europe (see Note 13b). The Company performs ongoing credit evaluations of its customers. The allowance for doubtful accounts is determined with respect to specific debts that are doubtful of collection according to management estimates (when the ageing of account receivable is more than 180 days). In certain circumstances, the Company may require letters of credit, other collateral or additional guarantees.

The Company has no off-balance-sheet concentration of credit risk such as foreign exchange contracts, option contracts or other foreign hedging arrangements.



m. Basic and diluted net earnings per share:

Basic net earnings per share is computed based on the weighted average number of ordinary shares outstanding during each year. Diluted earnings per share is computed based on the weighted average number of ordinary shares outstanding during each year, plus potential ordinary shares considered outstanding during the year, in accordance with Statement of Financial Accounting Standard No. 128, "Earnings Per Share" ("SFAS No. 128").

NOTE 3: OTHER ACCOUNTS RECEIVABLE AND PREPAID EXPENSES

| | DECEMBER 31, 2006 |
|---|---|
| Tax authorities | 99 |
| Deferred taxes | 17 |
| Employee advances | 6 |
| Deposits | 16 |
| | 138 |

NOTE 4: INVENTORIES

| | DECEMBER 31, 2006 |
|---|---|
| Materials | 479 |
| Work in progress | 31 |
| Provision for obsolescence | (7) |
| | 503 |



NOTE 5: TRADE RECEIVABLES

| | DECEMBER 31, |
|---|---|

| | 2006 |
|---|---|
| Trade receivables | 840 |
| Bills receivable | 258 |
| Allowance for doubtful accounts | - |
| | 1,098 |

NOTE 6: PROPERTY AND EQUIPMENT

| | DECEMBER 31, | | | |
|---|---|---|---|---|
| | 2005 | ADDITIONS | DISPOSALS | 2006 |
| COST: | | | | |
| Computers and peripheral equipment | 122 | 21 | - | 143 |
| Office furniture and equipment | 307 | 14 | (3) | 318 |
| Motor vehicles | 98 | 23 | (21) | 100 |
| Leasehold improvements | - | - | | |
| | 527 | 58 | (24) | 561 |
| ACCUMULATED DEPRECIATION: | | | | |
| Computers and peripheral equipment | (113) | (10) | - | (123) |
| Office furniture and equipment | (278) | (8) | 3 | (283) |
| Motor vehicles | (98) | (11) | 21 | (88) |
| Leasehold improvements | - | - | - | - |
| | (489) | (29) | 24 | (494) |
| DEPRECIATED COST | 38 | 29 | - | 67 |

Depreciation expenses for the years ended December 31, 2006 and 2005 were thousand (euro) 29 and 38, respectively.



NOTE 7: SHORT-TERM BANK DEBT

The Company has a short-term bank debt in the amount of thousand (euro) 17, bearing interest of 5%.

NOTE 8: ACCRUED EXPENSES AND OTHER LIABILITIES

| | DECEMBER 31, 2006 |
|---|---|
| Employees and payroll accruals | 52 |
| Income tax payable | 59 |

| | |
|---|---|
| Deferred tax | - |
| Tax authorities | 135 |
| Current Accounts | (80) |
| Warranty costs | 10 |
| | 176 |

NOTE 9: COMMITMENTS

The facilities of the Company are rented under operating leases for periods ending in 2009.

Future minimum lease commitments under non-cancelable operating leases as of December 31, are as follows:

| | |
|---|---|
| 2007 | 8 |
| 2008 | 8 |
| 2009 | 5 |
| | 21 |

Rent expenses for years ended December 31, 2006 and 2005, were approximately thousand (euro) 172 and 157, respectively. Rent expenses will be reviewed every year with the variation of the Consumer Price Index.



NOTE 10: TAXES ON INCOME

Reconciliation between the theoretical tax expense, assuming all income is taxed at the statutory tax rate applicable to income of the Company and the actual tax expense as reported in the statements of operations, is as follows:

| | YEAR ENDED DECEMBER 31, | |
|---|---|---|
| | 2006 | 2005 |
| Income before taxes as reported in the statements of operations | 255 | (75) |
| Non-deductible bad debt allowance and others 2004 | - | (82) |
| Non-deductible bad debt allowance 2005 | (20) | 20 |
| Tax depreciation | 37 | (37) |
| Increase (decrease) in the taxable base - Forward sales | 33 | 29 |
| Increase (decrease) in the taxable base - Unrealized severance allowance | (75) | 75 |
| Taxable income | 230 | (70) |
| Tax rates | 35% | 35% |
| Tax expense (benefit) | 80 | (25) |
| Decrease in taxes resulting from: | | |
| Tax deduction for development | (21) | - |

| | | |
|---|---|---|
| Deferred tax liability (asset) | - | (30) |
| TAXES ON INCOME, TAX EXPENSE (BENEFIT), AS REPORTED IN THE STATEMENTS OF OPERATIONS | 59 | (55) |

Under the current tax legislation, 35% of development expense can be deducted from the income tax with the limits of 35% of the theoretical tax charge. All the income before income taxes is domestic.



NOTE 11: RELATED PARTIES TRANSACTIONS

The balances with and the revenues derived from related parties (related parties are shareholders, directors and family of both) were as follows:

a. Payments to related parties:

| | YEAR ENDED DECEMBER 31, 2006 | 2005 |
|---|---|---|
| Wages | 332 | 299 |

In 2006 the payments of wages to related parties are based on the payments to the directors (thousand (euro) 290), the social security paid to the directors (thousand (euro) 18) and 20% from the leases (thousand (euro) 24).

b. Transactions with related parties were as follows:

| | YEAR ENDED DECEMBER 31, 2006 | 2005 |
|---|---|---|
| Sales to related parties | 29 | 39 |
| AMOUNTS CHARGED BY RELATED PARTIES: | | |
| Cost of revenues | 41 | 18 |



c. Amounts receivable from and payables to related parties:

| | DECEMBER 31, 2006 |
|---|---|
| RECEIVABLES: | |
| Mer Telemagement Solutions | 5 |
| MTS Asia | - |
| MTS IntegraTRAK | 1 |
| Jaraga BV. | 100 |

PAYABLES:
Mer Telemagement Solutions -

NOTE 12: SHAREHOLDERS' EQUITY

a. Share capital:

The ordinary shares entitle their holders the right to receive notice, to participate and vote in general meetings of the Company and the right to receive dividends, if declared.

b. Legal reserve

As established by the Spanish Companies' Act, 10% of profits must be allocated to the legal reserve, until such reserve is equal to 20% of share capital. The legal reserve shall not be distributed and may only be used for compensation of losses or to increase capital.

c. Shareholding

There are 15,052 ordinary shares of (euro) 0.0042 par value, authorized, issued and outstanding as of December 31, 2006.

The shareholders at December 31, 2006 are:

| | % |
|---|---|
| Jaraga, B.V. | 50% |
| Jose Lasry Nahon | 25% |
| Mauricio Toledano Marques | 25% |



d. Distribution of dividends.

The distribution of dividends amounting thousand (euro) 640 as a result of reserves distribution, has been paid to the shareholders in direct proportion of their shares.

| | |
|---|---|
| Jaraga, B.V. | 320 |
| Jose Lasry Nahon | 160 |
| Mauricio Toledano Marques | 160 |

NOTE 13:- SEGMENTS, CUSTOMERS AND GEOGRAPHIC INFORMATION

a. Major customers as a percentage of total revenues:

| | YEAR ENDED DECEMBER 31, | |
|---|---|---|
| | 2006 | 2005 |
| | % | |
| Adictis | 10% | 13% |
| Liberty Voz, S.L. | 6% | - |
| Cableuropa, S.A. | 6% | 8% |
| Siemens, S.A. | - | - |
| Telefonica de Espana | 5% | 5% |
| Eurotelefonia del Sur, S.L. | 4% | - |
| Siemens Chile | - | 2% |

| | | |
|---|---|---|
| Accentic | - | 2% |



b. The following is a summary of revenues within geographic areas based on end customer location:

| | YEAR ENDED DECEMBER 31, | |
|---|---|---|
| | 2006 | 2005 |
| Spain | 2,586 | 2,275 |
| European Community | 1,280 | 1,437 |
| Other | 487 | 855 |
| | 4,353 | 4,567 |

NOTE 14: SELECTED STATEMENTS OF OPERATIONS DATA

Financial income, net

| | YEAR ENDED DECEMBER 31, | |
|---|---|---|
| | 2006 | 2005 |
| Financial expenses: | | |
| Interest expenses | 6 | 3 |
| Other expenses | 27 | 6 |
| | 33 | 9 |
| Financial income: | | |
| Interest income | 39 | 29 |
| FINANCIAL INCOME, NET | 6 | 20 |



S I G N A T U R E S

The registrant hereby certifies that it meets all of the requirements for filing on Form 20-F and that it has duly caused and authorized the undersigned to sign this annual report on its behalf.

MER TELEMANAGEMENT SOLUTIONS LTD.

By: /s/ Eytan Bar
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Eytan Bar
Chief Executive Officer

By: /s/ Alon Mualem
---
Alon Mualem
Chief Financial Officer

Dated: April 8, 2008