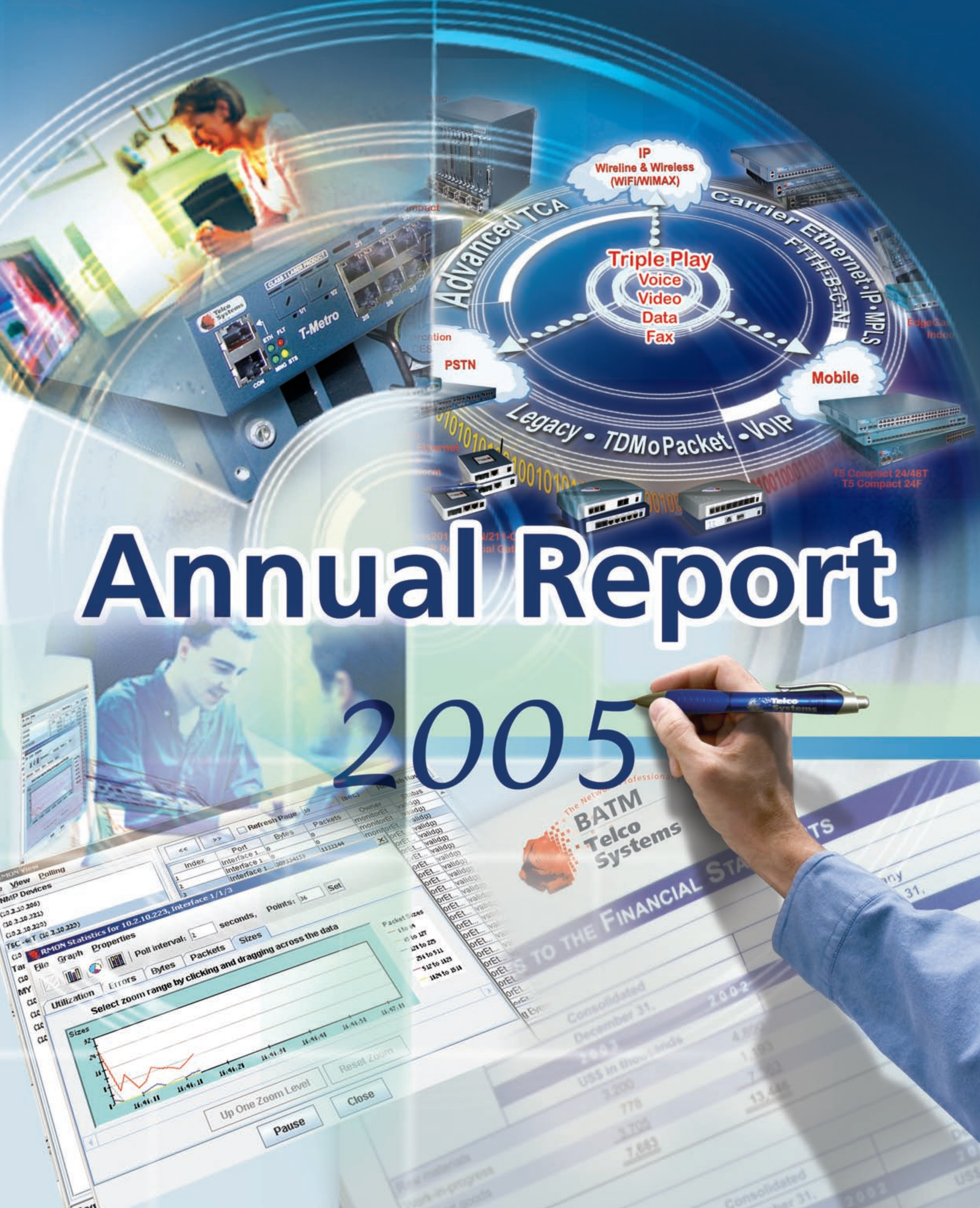
The Network Professional's Choice

BATM Telco Systems

Annual Report 2005



Directors and Advisers

Directors

P. Sheldon	Chairman, Non-executive
Dr. Z. Marom	Chief executive
O. Bar-Ner	Finance director
Dr. D. Kaznelson	Non-executive
A. Zochovitzky	Non-executive
K. Gavish	Non-executive

Registered Office

Kfar Netter, P.O.B.3737
Kfar Netter 40593.

Company Number

520042813

Auditors

Brightman Almagor & Co.
a member firm of
Deloitte Touche Tohmatsu
1 Azriely Center,
Tel-Aviv
Israel

Financial Advisers & Stock Brokers

Dresdner Kleinwort Wasserstein
30 Gresham Street
London EC2P 2XY
UK

Shore Capital
Bond Street House
14, Clifford Street
London W1X 1RE
UK

Corporate Solicitors in Israel

Lipa Meir & Co.
4, Itamar Ben-Avi Street
Tel-Aviv
Israel

Corporate Solicitors in the UK

Fladgate Fielder
25 North Row
London W1R 1DJ
UK

Bankers

Bank Hapoalim
Belinson, 1 Denmark Street
Petach-Tikva
Israel

Registrars

Capita Registrars
The Registry
74 Beckenham Road
Beckenham
Kent
BR3 4TU
UK

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Chairman's Statement

Review of the Year

I am delighted to report on a year that has more than justified my statement last year that "…2005 will prove to be the year in which the Company demonstrates that it has returned to a pattern of growth and profitability".

In the first half of the year we generated a substantial sales increase of 34%. We did even better in the second half, achieving an increase of 39%, making the increase 37% for the full year. Although this significant increase was gained at the cost of a small decrease in our gross margins, mainly in the US, our continued tight control of costs has resulted in the virtual elimination of annual operating losses.

These results have been achieved with little or no benefit from the recent important long-term contracts that the Company has gained with major industry players and which we confidently expect will provide further impetus to our future growth.

During the year we also reached the end of the heavy cost of goodwill amortization arising from our acquisition of Telco Systems in 2000 and this too has benefited our final results.

Financial Performance

Turnover for the period was $56,514,000 (2004: $41,218,000), an increase of 37.1% compared with 2004. Turnover for the second half of 2005 was $30,337,000 (2004: $21,757,000), an increase of 39.4%. This increase in the second half is mostly due to growth in our business with our strategic partners and VoIP based products including the new offerings from our Integral Access (now renamed Telco North (Boston)) operation which was acquired in July 2005.

Gross profit was $21,984,000 (2004: $17,540,000), representing an increase of 25.3% and a gross profit margin of turnover 39% (2004: 42.5%). As a result of new extended agreements with US carriers, we have experienced a decline in the profitability of our legacy business in the US. Since these agreements establish fixed pricing for the next few years, our focus will be to improve profitability by reducing the costs of some of our legacy products and by generating further growth in revenues from new products and maintenance agreements during the course of 2006.

R&D expenses in this period were $9,675,000 (2004: $9,909,000), representing a decrease of 2.4%. We have continued our strategy of increasing investment in IP based products and reducing investment in TDM based and legacy products.

Sales and Marketing expenses totalled $9,505,000 (2004: $8,984,000), representing an increase of 5.8%. As a percentage of sales, Sales and marketing expenses were 16.8% (2004: 21.8%). General and administrative expenses were $2,908,000 (2004: $3,394,000). Overall Sales, marketing and administration expenses have decreased from 30.0% of sales in 2004 to 22.0% in 2005.

Goodwill amortization was $2,713,000 (2004: $9,898,000). The majority of this relates to the acquisition of Telco Systems, the goodwill on which was finally fully amortized during H1 2005. It also includes the amortization of goodwill resulting from the acquisition of Integral Access.

Chairman's Statement

Finance income was $1,459,000 (2004: $1,702,000). This decrease is primarily as a result of reductions in the value of our marketable securities acquired as part of the sale of Eldor shares in 2004.

Other expenses in 2005 of $1,378,000 include the partial write-down of one of the Company's investments and the costs associated with the early termination of the lease agreement of one of our premises in the US. In 2004 other income of $423,000 included the gain on the sale of Eldor shares.

Pro forma profit after taxes, excluding the effect of the amortization of goodwill and other non-recurring expenses, was $1,168,000 (2004: loss $2,883,000). Actual loss after taxes, including the effect of goodwill amortization and other non-recurring expenses, amounted to $2,929,000 (2004: Loss $12,781,000), resulting in a loss per share of 0.75 cents (2004: Loss 3.29 cents).

Our balance sheet remains strong with cash (including short-term and long- term liquid investments) of $48.0m (2004: $50.7m) at the period end. Our cash position is slightly lower than in 2004 mainly due to an increase in inventory to support the significant growth in sales. We continue to exercise a conservative cash investment strategy, maintaining most balances in bank deposits.

Sales and Marketing

OEM

Our OEM business and VoIP offerings continued to be our major growth drivers in 2005. In the OEM segment we managed to both expand existing relationships, as announced in November 2005, as well as securing new relationships, as announced in February 2006. We expect this trend to continue during 2006. We also expect our investment in the Advanced TCA standard as well as our position as the world leader in quality of service of modern Triple IP networks to improve our chances of winning new customers as well as expanding our relationships with existing customers.

VoIP

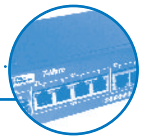
Our VoIP business has continued to grow for both the residential and corporate markets. We experienced significant sequential growth in the residential market as our customers continued to roll out their services. The integration of Integral Access' product offerings has improved our solution for business needs and forged a new relationship with an important customer, Time Warner Telecom. We expect to see further progress upon the introduction of our SIP based Integrated Access Devices that will appear in the market in the second half of 2006.

Far-East Market

We will also focus this year on expanding our business in the Far-East. As part of this initiative, we opened a branch in Singapore with a reputable locally residing executive to launch our presence in this region. We believe that there is significant opportunity for our IP based products in this area. We are looking to establish relationships with local carriers as well as cooperation with other vendors in the region.

Chairman's Statement

Research and Development and New Products

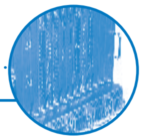


T-Marc

We have expanded our line of IP based product and launched the T-Marc. TELEPHONY® magazine (www.itmag.com) granted a 2005 Product of the Year Award to the Company's T-Marc product line, a family of extremely cost effective and compact intelligent Ethernet demarcation and service delivery customer premises equipment (CPE) devices. Greg Galitzine, editorial director of INTERNET TELEPHONY magazine, said:

"The challenge for carriers in delivering quality intelligent data and voice services over an Ethernet-based network is ensuring they meet a performance level that enterprises are used to and demand, Carriers can conquer this challenge by gaining control at the network edge, and T-Marc is one of the first intelligent demarcation devices to market."

This product complements our T-Metro which was released earlier in 2005.



AdvancedTCA®

In addition to our stand-alone advanced devices, we continue to develop IP based blades and cards for the AdvancedTCA® standard. This development is partly funded by some of our business partners. It will allow us to present a comprehensive solution of communication blades for this standard in 2006-2008. This standard, Advanced Telecommunication Computing Architecture, is gaining considerable traction both with telecom vendors and telecom service providers.

Access211N

In VoIP we continue to improve the performance and costs of our CPE gateways. In January 2006, we launched the Access211N, a next-generation SIP-based VoIP gateway for broadband internet telephone service. Through integrated routing capabilities, unique traffic shaping, and its implementation of advanced quality of service (QoS) standards, service providers and the end user enjoy superior voice quality and reduced cost since the need for an external router is eliminated.

Investment

In July 2005, we purchased certain assets and liabilities of Integral Access Inc., headquartered in Chelmsford, Massachusetts. We have completed the integration of this product line into Telco Systems' offerings.

Appreciation

The excellent results achieved this year have resulted from the extremely hard work of staff, at all levels and I would like to thank them for their invaluable contribution which is reflected in these figures. BATM is fortunate to have a dedicated and highly skilled team, working in a number of different countries who have demonstrated initiative and flair as well as dedication to the Company. We are determined that they should share in the success of the Company and during the year a significant number of employees benefited from the grant of shares in the Company's Option Scheme.

Chairman's Statement

Prospects

The recovery, which started in 2004 and accelerated during 2005, has continued further into the beginning of 2006. The agreements that have been signed with major partners and our substantial recent long-term project tender wins support our conviction that we have embarked on a period of substantial growth.

I am confident that 2006 will be a year when BATM will demonstrate that it has become a significant player in our industry.

Peter Sheldon
Chairman
15 March 2006

Brightman Almagor

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Independent Auditors' Report To the Shareholders of BATM Advanced Communications Ltd.

We have audited the accompanying balance sheets of **BATM Advanced Communications Ltd.** ("the Company") as of December 31, 2005 and 2004, and the consolidated balance sheets as of such dates, and the related income statements of the Company and consolidated and the consolidated statements of cash flows for each of the years ended on those dates. These financial statements are the responsibility of the Company's management and Board of Directors. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with generally accepted auditing standards in Israel including those prescribed by the Auditors' Regulations (Auditors' Mode of Performance) - 1973. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made board of directors and management, as well as evaluating the overall financial statements presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position - of the Company and consolidated - the Group as of December 31, 2005 and 2004, and the results of operations of the Company and consolidated and the consolidated cash flows for each of the years ended on those dates, in conformity with generally accepted accounting principles in Israel. As applicable to these financial statements, such accounting principles, are identical, in all material respects, to generally accepted accounting principles in the United Kingdom, except as described in Note 25.

As mentioned in Note 1d, the financial statements are presented in US dollars.

Brightman Almagor & Co.
Certified Public Accountants
A member firm of Deloitte Touche Tohmatsu
Israel, March 01, 2006

Consolidated Income Statements

US$ in thousands (except per share data)

	Note	Year ended December 31, 2005	2004
Revenues	3,4	56,514	41,218
Cost of revenues		34,530	(*)23,678
Gross profit		21,984	17,540
Operating expenses			
Research and development expenses, net	24	9,675	9,909
Sales and marketing expenses		9,505	(*)8,759
General and administrative expenses		2,908	3,619
Amortization of goodwill	11,14	2,713	9,898
Total operating expenses		24,801	32,185
Operating loss	5	(2,817)	(14,645)
Finance income, net	7	1,459	1,702
Other income (expenses), net	8	(1,378)	423
Loss before tax		(2,736)	(12,520)
Tax	9	(193)	(142)
Loss after tax		(2,929)	(12,662)
Company's share in results of associated company	14	-	(119)
Loss for the year		**(2,929)**	**(12,781)**
Loss per share (in cents)	10	**(0.75)**	**(3.29)**

(*) Reclassified

The accompanying notes are an integral part of these financial statements.

Income Statements Of The Company

US$ in thousands

	Note	Year ended December 31,	
		2005	2004
Revenues	3,4	26,632	17,226
Cost of revenues		16,320	10,227
Gross profit		10,312	6,999
Operating expenses			
Research and development expenses, net	24	5,265	4,444
Sales and marketing expenses		1,947	2,350
General and administrative expenses		1,316	1,267
Total operating expenses		8,528	8,061
Operating profit (loss)	5	1,784	(1,062)
Finance income, net	7	1,640	1,795
Other income (expenses), net	8	(298)	420
Income before tax		3,126	1,153
Tax	9	(193)	(150)
Income after tax		2,933	1,003
Company's share in results of subsidiaries and associated company	14	(5,862)	(13,784)
Loss for the year		**(2,929)**	**(12,781)**

The accompanying notes are an integral part of these financial statements.

Consolidated Balance Sheets

US$ in thousands

	Note	December 31, 2005	December 31, 2004
Non-current assets			
Goodwill	11	1,678	2,475
Property, plant and equipment	12	10,477	10,587
Investment in companies	14	3,388	3,688
Long-term investments	13	8,635	3,098
		24,178	19,848
Current assets			
Inventories	15	10,445	7,425
Short-term investments	13	20,856	46,478
Trade and other receivables	16	10,794	9,779
Cash and cash equivalents	23	18,477	1,153
		60,572	64,835
Total assets		**84,750**	**84,683**
Current liabilities			
Trade and other payables	17	15,331	13,223
Net current assets		45,241	51,612
Non-current liabilities			
Liability for employee termination benefits, net	19	372	376
Other long-term liabilities	18	760	-
		1,132	376
Total liabilities		16,463	13,599
Net assets		**68,287**	**71,084**
Equity			
Share capital	20	1,178	1,177
Share premium account		397,680	397,549
Foreign currency translation adjustment		16	16
Deficit		(330,587)	(327,658)
Total equity		**68,287**	**71,084**

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

Z. Marom
Chief Executive Officer and Director

O. Bar-Ner
Chief Financial Officer and Director

Balance Sheets Of The Company

US$ in thousands

	Note	December 31, 2005	December 31, 2004
Non-current assets			
Property, plant and equipment		2,589	2,612
Investments in subsidiaries	14	11,531	15,739
Investment in companies	14	3,388	3,688
Long-term investments	13	8,635	3,098
		26,143	25,137
Current assets			
Inventories	15	2,858	2,443
Short-term investments	13	17,773	46,478
Trade and other receivables	16	15,037	7,532
Cash and cash equivalents		16,255	375
		51,923	56,828
Total assets		**78,066**	**81,965**
Current liabilities			
Trade and other payables	17	7,851	8,682
Net current assets		44,072	48,146
Non-current liabilities			
Liabilities for subsidiaries	14	1,599	1,875
Liability for employee termination benefits, net	19	329	324
		1,928	2,199
Total liabilities		9,779	10,881
Net assets		**68,287**	**71,084**
Equity			
Share capital	20	1,178	1,177
Share premium account		397,680	397,549
Foreign currency translation adjustment		16	16
Deficit		(330,587)	(327,658)
Total equity		**68,287**	**71,084**

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

Consolidated Statements Of Cash Flows

US$ in thousands

	Note	Year ended December 31, 2005	Year ended December 31, 2004
Net cash used in operating activities	21	(2,092)	(1,924)
Investing activities			
Proceeds from disposal of (investment in) short term investments		(12,110)	1,040
Investment in long term investments		(8,423)	-
Proceeds from disposal of long term investments		40,959	-
Repayment of loan by associated company		-	477
Purchases of property, plant and equipment		(692)	(1,767)
Acquisition of subsidiary	22	(200)	-
Net cash from (used in) investing activities		19,534	(250)
Financing activities			
Repayment of bank loan		(250)	-
Exercise of share based options by employees		132	9
Net cash from (used in) financing activities		(118)	9
Increase (decrease) in cash and cash equivalents		17,324	(2,165)
Cash and cash equivalents at the beginning of the year		1,153	3,318
Cash and cash equivalents at the end of the year	23	**18,477**	**1,153**

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

Notes To The Consolidated Financial Statements

US$ in thousands

Note 1 - General Information

a. The Company was incorporated in Israel in January 1992 under the Israeli company law. The address of the registered office is P.O.B. 3737 Kfar Netter 40593, Israel. The Company is engaged in the research and development, production and marketing of data communication products in the field of local and wide area networks and premises management systems.

The Company's shares are traded in the London Stock Exchange.

b. The industry in which the Company and its subsidiaries (the "Group") operate is characterized by rapid technological development in a highly competitive environment. The Company depends on a limited number of suppliers and for some components and subcontracting services, a sole supplier. Any disruption or termination of the suppliers' operations may adversely affect the Company's production capabilities.

c. Use of Estimates in Preparation of Financial Statements

The preparation of financial statements in conformity with generally accepted accounting principles ("GAAP") requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities as of the date of the financial statements, and the reported amounts of revenues and expenses during the reporting periods. Actual results could differ from those estimates.

d. The financial statements are presented in US Dollars ("dollar" or "$") as the dollar is the functional currency of the Group, see Note 2 "**b**". Foreign operations are included in accordance with the policies set out in Note 2 "**h**".

Note 2 - Significant Accounting Policies

a. Basis of accounting

The financial statements are prepared in accordance with Israeli generally accepted accounting principals ("GAAP") As applicable to these financial statements, such accounting principals, are identical in all material respects, to GAAP in the United Kingdom GAAP, except as described in Note 25.

b. Presentation of financial information

The financial information has been prepared under the historical cost convention in dollar. The dollar is the functional currency of the Group. Transactions and balances denominated in dollars are presented at their original amounts. Transactions and balances in other currencies are translated into dollars. All exchange gains and losses arising from the translation of monetary balance sheet items are reflected in the income statement as they arise.

c. Basis of consolidation

The consolidated financial statements include the financial statements of the Company and those companies over whose operations the Company has effective control ("the subsidiaries"). Effective control is achieved where the Company has the power to govern the financial and operating policies of an investee entity so as to obtain benefits from its activities. The results of subsidiaries acquired or disposed of during the year are included in the consolidated income statements from the effective date of acquisition or up to effective date of disposal, as appropriate. Where necessary, adjustments are made to the financial statements of subsidiaries to bring the accounting policies used into line with those used by the group. All intra-group transactions, balances, income and expenses are eliminated on consolidation.

Notes To The Consolidated Financial Statements

US$ in thousands

Note 2 - Significant Accounting Policies (Cont.)

d. Cash Flows

The financial statements do not include a statement of cash flows on a stand-alone basis for the Company since, in the opinion of Management; it would not add significant information to the financial statements.

e. Goodwill

The excess of cost over the Group's share of the net book value of the subsidiaries at the date of acquisition, which cannot be assigned to an identifiable asset, is recorded as goodwill and is amortized over a five to ten-year period based on the straight-line method. Any excess cost that can be assigned to a specific asset is amortized over the same period as that asset. For impairment of long-lived assets, see "**l** " below.

f. Revenue recognition

Revenue is measured at the fair value of the consideration received or receivable and represents amounts receivable for goods and services provided in the normal course of business, net of discount, VAT and other sales related taxes.

Revenue from product sales is generally recorded on delivery to the customer, provided that no significant vendor obligations remain outstanding and collection of the related receivable is deemed probable by management.

g. Leasing

Leases are classified as finance leases whenever the terms of the lease transfer substantially all the risks and rewards of ownership to the lessee. All other leases are classified as operating leases. All the Group's leases are operating leases.

h. Foreign currencies, Exchange rates and Linkage basis

On consolidation, the assets and liabilities of the Group's companies whose functional currency is other then the dollar are translated at exchange rates prevailing on the balance sheet date. Income and expense items are translated at the average exchange rates for the period unless exchange rates fluctuate significantly. Exchange differences arising, if any, are classified as equity and transferred to the Group's translation reserve. Such translation differences are recognized as income or as expenses in the period in which the operation is disposed of.

Balances in or linked to currencies other than the dollar are included at the rate of exchange prevailing at the balance sheet date. Details of the changes in the rates of exchange of non-dollar currencies relative to the dollar are as follows:

	As at December 31,	
	2005	2004
Change in the year – increase (decrease)		
New Israeli Shekel	(6.41)%	1.65%
Pound Sterling	(10.54)%	7.57%
Euro	(13.26)%	7.96%

i. Research and development expenditure

Research and development expenses, net of related grants, are expensed as incurred.

Notes To The Consolidated Financial Statements

US$ in thousands

Note 2 - Significant Accounting Policies (Cont.)

j. Cash and cash equivalents

Cash and cash equivalents include deposits in banks with an original maturity of three months or less.

k. Marketable securities

Marketable securities are presented in accordance with principles set by standard 44 of the Institute of Certified Public Accountants in Israel.

l. Property, Plant and Equipment

Property, plant and equipment are presented at cost less accumulated depreciation and amortization. Depreciation is calculated based on the straight-line method, at annual rates sufficient to write off the assets over their estimated useful lives. In respect of the leasehold improvements, amortization is calculated over the period of the lease.

Rates of depreciation and amortization are as follows:	%
Computers and manufacturing equipment	10-33
Motor vehicles	15
Office furniture and equipment	10
Building	2

In accordance with Standard No.15 of the Israeli Accounting Standards Board, "Impairment of Assets" management reviews long-lived assets on a periodic basis, as well as when such a review is required based upon relevant circumstances, to determine whether events or changes in circumstances indicate that the carrying amount of such assets may not be recoverable. An impairment charge is recorded in the event the carrying amount of an asset exceeds its recoverable value. An asset's recoverable value is the higher of the asset's net selling price and the asset's value in use, the latter being equal to the asset's discounted expected cash flows.

m. Inventories

Inventories are stated at the lower of cost and net realizable value. Cost is determined on the "first-in-first-out" basis in respect of raw materials. Finished goods and work in progress are stated at cost, which includes direct labor costs, subcontractors and certain other indirect costs

n. Investments

Investments in subsidiaries in the Company's balance sheets and the Group's investments in a Company in which the Group had no effective control but had, until July 2004 "significant influence" ("the associated Company"), are presented under the equity method i.e., the investments are presented at cost, plus (less) the share in the net earnings (losses) of the respective entities or other changes in equity which have occurred since acquisition or establishment of the companies.

The excess of cost over the share of the net book value of subsidiaries and associated company at the date of acquisition that cannot be directly allocated to a specific asset is amortized over a five to ten-year period based on the straight-line method. Any excess cost that can be allocated to a specific asset is amortized over the same period as such asset.

Investments in companies in which the Company does not have a significant influence are presented at cost less a write down for other then temporary decline in the value of the investment.

Notes To The Consolidated Financial Statements

US$ in thousands

Note 2 - Significant Accounting Policies (Cont.)

o. Trade receivable

Trade receivables do not carry any interest and are stated at their nominal value as reduced by appropriate allowances for estimated irrecoverable amounts.

p. Trade payable

Trade payables are not interest bearing and are stated at their nominal value.

q. Provisions

Provisions for warranty costs are recognized at the date of sale of the relevant products, at the directors' best estimate of the expenditure required to settle the Group's liability.

r. Deferred tax

Deferred tax is the tax expected to be payable or recoverable on differences between the carrying amounts of assets and liabilities in the financial statements and the corresponding tax bases used in the computation of taxable profit, and is accounted for using the balance sheet liability method. Deferred tax liabilities are generally recognized for all taxable temporary differences and deferred tax assets are recognized to the extent that it is probable the taxable profits will be available against which deductible temporary differences can be utilize. Such assets and liabilities are not recognized if the temporary difference arises from goodwill or from the initial recognition (other than in a business combination) of other assets and liabilities in a transaction that affects neither the tax profit nor the accounting profit.

Deferred tax liabilities are recognized for taxable temporary differences arising on investments in subsidiaries and associates, except were the Group is able to control the reversal of the temporary difference and it is probable that the temporary difference will not reverse in the foreseeable future.

The carrying amount of deferred tax assets is reviewed at each balance sheet date and reduced to the extent that it is no longer probable that sufficient taxable profits will be available to allow all or part of the asset to be recovered.

Deferred tax is calculated at the tax rates that are expected to apply in the period when the liability is settled or the asset is realized. Deferred tax is charged or credited in the income statement, except when it relates to items charged or credited directly to equity, in which case the deferred tax is also dealt with equity.

s. Fair value of financial instruments

A financial instrument is defined as cash, evidence of an ownership interest in an entity, or a contract that impose on one entity a contractual obligation either to deliver cash or receive cash or another financial instrument to or from a second entity. Examples of financial instruments include cash and cash equivalents, marketable securities, securities held to maturity, trade accounts receivable, loans, investments, trade accounts payable, accrued expenses, options and forward contracts.

At December 31, 2005 and 2004 the fair market value of the Company's financial instruments did not materially differ from their respective book value.

Notes To The Consolidated Financial Statements

US$ in thousands

Note 2 - Significant Accounting Policies (Cont.)

t. Recent Accounting Pronouncements by the Israeli Accounting Standards Board

(1) Accounting Standard No. 19 "Taxes on Income"

In July 2004, the Israeli Accounting Standard Board published Accounting Standard No. 19 "Taxes on Income" (the "Standard") which is based on IAS No. 12. The Standard established the guidelines for recognizing, measuring, presenting and disclosing taxes on income in the financial statements. The Standard is effective for financial statements relating to reporting periods commencing on, or after, January 1, 2005. The adoption of the provisions of the Standard did not have a material effect on the Company's financial statements.

(2) Accounting Standard No. 21 "Earnings Per Share"

In February 2006, the Israeli Accounting Standards Board approved for publication Accounting Standard No. 21, "Earnings Per Share" (the "Standard"). With the initial adoption of the Standard, Opinion No. 55 of the Institute of Certified Public Accountants in Israel - Earnings per share will be cancelled. The Standard prescribes that an entity shall calculate basic earnings per share amounts for profit or loss attributable to ordinary equity holders of the parent entity and, if presented, profit or loss from continuing operations attributable to those equity holders. The basic earnings per share shall be calculated by dividing profit or loss attributable to ordinary equity holders of the parent entity (the numerator) by the weighted average number of ordinary shares outstanding (the denominator) during the reported period.

For the purpose of calculating diluted earnings per share, an entity shall adjust profit or loss attributable to ordinary equity holders of the parent entity, and the weighted average number of shares outstanding, for the effects of all dilutive potential ordinary shares. The Standard is effective for financial statements for periods commencing January 1, 2006 or thereafter. The initial adoption of the Standard will be accounted for retrospectively and comparative Earnings per share data for prior periods shall be adjusted. The application of the Standard is not expected to materially affect the Company's Earnings per share data.

(3) Accounting Standard No. 22 "Financial Instruments: Disclosure and Presentation"

In July 2005, the Israeli Accounting Standards Board approved for publication Accounting Standard No. 22 "Financial Instruments: Disclosure and Presentation" (the "Standard"). A financial instrument under this Standard is defined, in general, as any contract that establishes a financial asset of an entity, or a financial liability or equity instrument of another entity. This Standard establishes the requirements for presentation of financial instruments in the financial statements and indicates the information that should be disclosed in relation thereto, and, in certain cases, the method to measure their impact on the entity's financial statements. The presentation requirements relate to the classification of financial instruments as financial assets, financial liabilities or equity instruments. It also deals with the classification of related interest, dividends, losses and gains and to the circumstances under which financial assets and financial liabilities derived from financial instruments are to be offset. The Standard establishes requirements for disclosure of information relating to factors affecting the amount, timing and certainty of the entity's future cash flows relating to financial instruments and accounting policy implemented in respect of these instruments. The Standard also establishes requirements for disclosure of information about the nature and the extent of an entity's use of financial instruments, the business purposes they serve, the risks associated with them and management's policies for the oversight of those risks.

The Standard is effective for financial statements for periods commencing January 1, 2006 or thereafter. The initial adoption of the Standard will be accounted for by the "prospective method", i.e. financial instruments issued before the effective date of the Standard will be classified and presented in accordance with its provisions commencing from the effective date. Comparative financial statements for prior periods are not to be adjusted. The new Standard supersedes Opinion No. 53 "Accounting for Convertible Liabilities" and Opinion No. 48 "Accounting for Options".

The application of the Standard is not expected to materially affect the Company's financial statements.

Note 2 - Significant Accounting Policies (Cont.)

(4) Accounting Standard No. 24 "Share-Based Payments"

In September 2005, the Israeli Accounting Standards Board published Accounting Standard No. 24 "Share-Based Compensation" (the "Standard"), which calls for the recognition in the financial statements of share-based payments, including transactions with employees, which are to be settled by the payment of cash, by other assets, or by equity instruments. Under Standard No. 24, amongst other matters, costs associated with grants of shares and options to employees will be expensed over the vesting period of each grant. Said costs will be determined based on the fair value of the grants at each grant date. The Standard establishes guidelines for measuring the fair value of each grant based on the settlement terms (either by cash or equity instrument), and disclosure provisions.

The Standard is effective for financial statements for periods commencing January 1, 2006 or thereafter. The Standard provides that with respect to Share-based payments to be settled by equity instruments, its provisions should be applied to all grants made after March 15, 2005, that are unvested as of December 31, 2005. The Standard further provides that its provisions should be applied to modifications that were made after March 15, 2005, even if the underlying grants are not in the scope of the Standard.

Would the Company elect to early adopt the Standard already in 2005 (for grants and modifications made after March 15, 2005), the 2005 loss and loss per share would have been higher by $284 and by 0.07 cent per share, respectively.

(5) Accounting Standard No. 25 "Revenues"

In February 2006, the Israeli Accounting Standards Board approved for publication Accounting Standard No. 25, "Revenues" (the "Standard").

This Standard establishes the requirements for recognition criteria, measurement, disclosure and presentation of revenues arising from sale of goods, rendering of services and from the use by others of entity assets yielding interest, royalties and dividends. This Standard prescribes that revenue shall be measured at the fair value of the consideration received or receivable.

The Standard is effective for financial statements for periods commencing January 1, 2006 or thereafter.

Assets and liabilities included in the financial statements as of December 31, 2005 in different amounts from those that would have been presented if the standard's requirements were applied will be adjusted on January 1, 2006 to the amounts to be recognized in accordance with the Standard's guidelines. The results of the initial adoption of the Standard as at January 1, 2006 shall be accounted for by the cumulative effect of a change in accounting method.

The application of the Standard is not expected to materially affect the Company's financial position and results of operations.

u. Reclassification

Certain previously reported amounts have been reclassified in these financial statements in order to conform with the 2005 financial statements presentation.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

US$ in thousands

NOTE 3 - REVENUES

An analysis of revenues is as follows:

	Consolidated		Company	
	Year ended December 31,		Year ended December 31,	
	2005	2004	2005	2004
Sales of goods	54,690	39,745	25,830	16,821
Services	1,541	1,008	802	405
Property rental income	283	465	-	-
	56,514	**41,218**	**26,632**	**17,226**

For the year ended December 31, 2005, five customers constitute approximately 55% of the total consolidated revenues, each constituting more than 5%. The major one constitutes -24%. (For the year ended December 31, 2004: three customers, 37% and 21%, respectively). For the year ended December 31, 2005 two customers constitute approximately 83% of the Company's revenues. The major one constitutes 51%. (For the year ended December 31, 2004 three customers, 82% and 49%, respectively).

NOTE 4 - GEOGRAPHIC SEGMENTS

1. The Group's principle operations are located in Israel, America, Europe and Far East. The following table provides an analysis of the Group's sales by geographical markets, irrespective of the origin of the goods/ services:

	Consolidated		Company	
	Year ended December 31,		Year ended December 31,	
	2005	2004	2005	2004
Europe	18,039	14,592	15,930	12,876
America (mainly North America)	35,331	23,755	8,711	3,978
Israel	1,646	2,196	689	136
Far East	1,475	610	1,296	236
Other	23	65	6	-
	56,514	**41,218**	**26,632**	**17,226**

Notes To The Consolidated Financial Statements

US$ in thousands

Note 4 - Geographic Segments (Cont.)

2. The following is an analysis of the carrying amount segment assets (excluding cash and cash equivalent and short and long term investments), and additions to property, plant and equipment and intangible assets, analyzed by geographical area in which the assets are located:

	Carrying amount of segment assets		Additions to property, plant and equipment and intangible assets	
	Year ended December 31,		Year ended December 31,	
	2005	2004	2005	2004
Israel	10,753	11,345	533	1,579
America (mainly North America)	15,929	12,640	2,069	175
Europe	5,198	6,113	6	13
Far East	1,514	168	-	-
	33,394	**30,266**	**2,608**	**1,767**

Note 5 - Loss From Operations

	Consolidated		Company	
	Year ended December 31,		Year ended December 31,	
	2005	2004	2005	2004
Arrived at after charging				
Directors' remuneration (excluding executives)	79	70	79	70
Depreciation of property, plant and equipment	1,245	1,408	550	489
Amortization of intangible assets	2,713	9,898	-	-
Staff costs (see note 6)	12,713	12,349	4,692	4,129
Auditors' remuneration for audit services (see below)	120	120	40	40

(*) Amount payable to Brightman Almagor & Co. and their associates by the Company and its Israeli subsidiaries undertakings in respect of non-audit services were $17,000 (there was no non-audit services in 2004)

	Consolidated		Company	
	Year ended December 31,		Year ended December 31,	
	2005	2004	2005	2004
Audit services	120	120	40	40
Tax services	5	-	5	4
Advisory services	12	-	12	-
Internal auditor	5	7	5	7
	142	**127**	**62**	**51**

Notes To The Consolidated Financial Statements

US$ in thousands

Note 6 - Staff Costs

	Consolidated		Company	
	Year ended December 31,		Year ended December 31,	
	2005	2004	2005	2004
a. The average monthly number of employees during each year, including executive directors:	198	209	97	90
b. Staff costs for all employees, including directors, consist of:				
Wages and salaries	9,492	9,286	3,285	2,905
Social security costs	3,221	3,063	1,407	1,224
	12,713	**12,349**	**4,692**	**4,129**
c. Executive Directors' emoluments:				
CEO and CFO(1)	**348**	**619**	**348**	**363**

(1) On March 1, 2006 the remuneration committee recommended to the Board and to the Shareholders' Meeting to pay the CEO a bonus of $100 gross (not yet provided for in the 2005 financial statments) for his achievement in 2005, this bonus will be paid subject to the approval of Shareholders in the next Annual general meeting.

Note 7 - Finance Income, Net

	Consolidated		Company	
	Year ended December 31,		Year ended December 31,	
	2005	2004	2005	2004
Interest on bank deposits, net	1,484	1,758	1,642	1,798
Gain (loss) on marketable securities	(7)	27	(7)	27
Exchange rate differences, net	(18)	(83)	5	(30)
	1,459	**1,702**	**1,640**	**1,795**

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

US$ in thousands

NOTE 8 - OTHER INCOME (EXPENSES), NET

	Consolidated		Company	
	Year ended December 31,		Year ended December 31,	
	2005	2004	2005	2004
Costs associated with the early termination of lease agreement	(1,084)	-	-	-
Write-down of an investment	(300)	-	(300)	-
Gain from selling an Investment in associated company	-	410	-	410
Others	6	13	2	10
	(1,378)	**423**	**(298)**	**420**

NOTE 9 - TAX

a. Current tax:

	Consolidated		Company	
	Year ended December 31,		Year ended December 31,	
	2005	2004	2005	2004
Israeli corporation tax	(7)	150	(7)	150
Foreign tax	200	(8)	200	-
	193	**142**	**193**	**150**

b. The charge for the year can be reconciled to the profit per the income statement as follows:

	Company			
	Year ended December 31,		Year ended December 31,	
	2005		2004	
	US$	%	US$	%
Profit before tax	3,126		1,153	
Tax at the Israeli corporation tax rate of 34% (2004 35%)	1,063	34	404	35
Tax effect of utilization of tax losses not previously recognized	(870)		(254)	
Tax expense and effective tax rate for the year	**193**	**6**	**150**	**13**

Notes To The Consolidated Financial Statements

US$ in thousands

Note 9 - Tax

c. Taxation under various laws:

The Company and its Israeli subsidiaries are assessed under the provisions of the Income Tax Law (Inflationary Adjustments), 1985, pursuant to which the results for tax purposes are measured in Israeli currency in real terms in accordance with changes in the Israeli CPI. The Company and its subsidiaries are assessed for tax purposes on an unconsolidated basis.

Since acquisition, Telco Systems had losses for tax purposes. In addition, in accordance with US tax law, Telco Systems made an election to amortize a substantial part of the excess cost paid in its acquisition over a period of 15 years. The said have resulted in tax losses carry forward with an expiration dates, in significant amount of which the future utilization is uncertain.

d. "Industrial Company"

The Company is an "industrial company" as defined in the Israeli Law for the Encouragement of Industry (Taxes) 1969, and, as such, is entitled to certain tax benefits, mainly increased depreciation rates, the right to claim public issuance expenses and the amortization of patents and other intangible property rights as a deduction for tax purposes.

e. "Approved Enterprise"

The production facilities of the Company have been granted "approved enterprise" status in three separate programs under the Law for the Encouragement of Capital Investments, 1959, as amended. Under this law, income attributable to each of these programs (in a manner prescribed in such law and its regulations) is fully exempt from tax for eight to ten years.

Such period of benefits commences on the first year in which the enterprise generates taxable income (The expiry date of the period of benefits is limited to the earlier of twelve years from commencement of production or fourteen years from the date of the approval.) The period of benefits of the first program commenced in 1992 and ended in 2000.

One of the Israeli subsidiaries has also been granted an Approved Enterprise status for the construction of the Company's plant at Yokneam, on terms similar to the above mentioned.

In the event of a distribution of a cash dividend out of tax-exempt income, as above, the Company will be liable to corporate tax at a rate of 10%-25% (depending on the percentage of foreign shareholders in the Company's equity), in respect of the amount distributed.

On July 25, 2005 an amendment to the Israeli tax law was approved by the Israeli parliament which reduces the tax rates imposed on Israeli companies to 31% for 2006; this amendment states that the corporate tax rate will be further reduced in subsequent tax years as follows: in 2007 29%, in 2008 27%, in 2009 26% and thereafter 25%. This change does not have a material effect on the Company's financial statements.

f. Tax assessments

The Company has received final tax assessments for the years up to and including the 2002 tax year. The subsidiaries have not been assessed for tax since their incorporation.

Note 10 - Loss Per Share

Loss per share is based on the loss for the year and the weighted average number of shares in issue throughout each year. The number of shares used in the calculation for 2005 was 388,578,761 (2004 - 388,486,036).

Notes To The Consolidated Financial Statements

US$ in thousands

Note 11 - Goodwill (Consolidated)

The balance as of December 31, 2005 represents the excesses cost at the acquisition by Telco of the operations of Integral Access, a US corporation, in July 2005 (cost of $1,916 less accumulated amortization of $239). See also ,Note 22. The balance as of December 31, 2004 represents the excess cost in the acquisition by the Company of Telco Systems in 2000, amortized or impaired in full by December 31, 2005.

Note 12 - Property, Plant and Equipment (Consolidated)

	Building	Computers and manufacturing equipment	Motor vehicles	Office furniture and equipment	Leasehold improvements	Total
Acquisition Cost						
At January 1, 2004	7,701	9,298	19	1,001	126	18,145
Acquisitions	936	793	-	38	-	1,767
At December 31, 2004	8,637	10,091	19	1,039	126	19,912
Acquisitions	-	664	-	28	-	692
Disposals		(15)		(11)	-	(26)
Subsidiary acquired	-	439	-	4	-	443
At December 31, 2005	8,637	11,179	19	1,060	126	21,021
Accumulated depreciation						
At January 1, 2004	498	6,780	3	531	105	7,917
Charge for the year	161	1,147	3	94	3	1,408
At December 31, 2004	659	7,927	6	625	108	9,325
Charge for the year	170	1,001	3	69	2	1,245
Disposals	-	(15)	-	(11)	-	(26)
At December 31, 2005	829	8,913	9	683	110	10,544
Net book value						
At December 31, 2005	**7,808**	**2,266**	**10**	**377**	**16**	**10,477**
At December 31, 2004	**7,978**	**2,164**	**13**	**414**	**18**	**10,587**

Notes To The Consolidated Financial Statements

US$ in thousands

Note 13 - Long-Term and Short-Term Investments

	Consolidated		Company	
	December 31,		December 31,	
	2005	2004	2005	2004
Interest-bearing Bank deposits	18,389	42,065	18,389	42,065
Bonds- held to maturity	6,526	4,729	6,526	4,729
Marketable Securities	1,493	2,782	1,493	2,782
ETF'S (1)	3,083	-	-	-
	29,491	**49,576**	**26,408**	**49,576**
Included in short-term investments	**20,856**	**46,478**	**17,773**	**46,478**
Included in long-term investments	**8,635**	**3,098**	**8,635**	**3,098**

(1) Represents the Group's investments in Index funds.

Note 14 - Investments in Subsidiaries and Other Companies

a.1 Details of investments in companies are as follows:

	Country of incorporation	Percentage shareholding at December 31, 2005	December 31, 2005	December 31, 2004
Subsidiaries (b. below)(Company)				
Telco Systems Inc.	USA	100%	3,131	5,442
Batm Real Estate Ltd.	Israel	100%	6,353	6,458
Netwiz Ltd	Israel	100%	1,997	3,781
Others, net		100%	50	58
			11,531	**15,739**
Other companies (Company and Consolidated)				
Netstar Technology Corporation	Taiwan	15.94%	3,087	3,087
Lynx Photonic Networks Inc	Israel	2.87%	301	601
			3,388	**3,688**
			14,919	**19,427**

(1) On July 2004 the Company sold its investment in Eldor Computers Limited (cost $743) in exchange for 430,000 marketable shares in Taldor Computer Systems Ltd valued at the date of sale at $1,153 giving a profit of $410 included in other income for the year ended December 31, 2004 and the full repayment of the loan granted to that company.

Notes To The Consolidated Financial Statements

US$ in thousands

Note 14 - Investments in Subsidiaries and Other Companies (Cont.)

a.2 Details of liabilities due from subsidiaries are as follows:

	Country of incorporation	Percentage shareholding at December 31, 2005	December 31, 2005	December 31, 2004
Liabilities for Subsidiaries (b.below)(Company)				
Batm GMBH.	Germany	100%	1,238	1,506
Others, net		100%	361	369
			1,599	**1,875**

b. Composition of investment and liabilities in subsidiaries:

	Company December 31, 2005	Company December 31, 2004
Net assets at the date of acquisition	18,767	18,767
Goodwill at original cost	335,739	335,739
Company's shares of post-acquisition losses (1)	(361,247)	(355,385)
Foreign currency translation adjustments	16	16
Dividend distribution by Netwiz	(1,527)	-
Long-term inter-company accounts	18,184	14,727
	9,932	**13,864**

(1) After the amortization of goodwill of $2,713 and $9,898 for the years ended December 31, 2005 and 2004 respectively.

Note 15 - Inventories

	Consolidated December 31,		Company December 31,	
	2005	2004	2005	2004
Raw materials	4,640	3,588	1,527	854
Work-in-progress	640	611	426	219
Finished goods	5,165	3,226	905	1,370
	10,445	**7,425**	**2,858**	**2,443**

Notes To The Consolidated Financial Statements

US$ in thousands

Note 16 - Trade and Other Receivables

	Consolidated		Company	
	December 31,		December 31,	
	2005	2004	2005	2004
Trade debtors (1)	9,463	8,436	3,470	2,612
Participation in research and development:				
Government of Israel	353	151	353	151
Others	-	234	-	234
Related parties	-	-	10,790	3,982
Value added tax	275	370	275	370
Tax authorities	30	29	-	-
Prepaid expenses and other debtors	673	559	149	183
	10,794	**9,779**	**15,037**	**7,532**

(1) Net of provision for doubtful accounts in the consolidated financial statements for the year ended December 31, 2005 and 2004 of $1,077 and $830 respectively (Company: $476 and $479 respectively).

Note 17 - Trade and Other Payables

	Consolidated		Company	
	December 31,		December 31,	
	2005	2004	2005	2004
Trade creditors	8,041	7,618	4,343	4,379
Wages and related accruals	1,954	1,757	786	808
Related parties	341	364	2,068	3,068
Tax authorities	171	-	171	-
Value added tax	7	127	-	-
Other creditors and accruals	4,817	3,357	483	427
	15,331	**13,223**	**7,851**	**8,682**

Notes To The Consolidated Financial Statements

US$ in thousands

Note 18 - Provisions (Consolidated)

	Warranty provision	Contingent consideration resulting from the acquisition of a subsidary	Total
At January 1, 2004	582	-	582
Utilization of provision	(145)	-	(145)
At December 31, 2004	437	-	437
Utilization of provision	(281)	-	(281)
On acquisition of subsidiary	613	1,140	1,753
At December 31, 2005	**769**	**1,140**	**1,909**
Included in other current liabilities	**769**	**380**	**1,149**
Included in non-current liabilities	**-**	**760**	**760**

The warranty provision represents management's best estimate of the Group's liability under one year to ten years warranties granted on electronic products, based on past experience and industry averages for defective products.

Note 19 - Liability for Employee Termination Benefits, net

	Consolidated		Company	
	December 31,		December 31,	
	2005	2004	2005	2004
Amount funded for severance pay	193	183	193	183
Less - liability	(565)	(559)	(522)	(507)
	(372)	**(376)**	**(329)**	**(324)**

Notes To The Consolidated Financial Statements

US$ in thousands

Note 19 - Liability for Employee Termination Benefits, net (Cont.)

The Group's liability for severance pay is fully provided pursuant to local laws or respective agreements. Part of the Group's liability is funded through amounts deposited with severance pay funds and insurance policies. The insurance policies are owned by the Company and have been entered into by the Company on behalf of individual employees. The amounts accumulated with the insurance Company and the savings funds are not under the Company's control or management, and therefore are not reflected in the Company's balance sheet.

Note 20 - Share Capital

The share capital of the Company is as follows (number of shares):

	December 31, 2005		December 31, 2004	
	Authorized	Issued and fully paid	Authorized	Issued and fully paid
Ordinary shares of NIS 0.01 par value	1,000,000,000	388,961,117	1,000,000,000	388,533,713

a. The shares of the Company are traded on the London Stock Exchange.

b. During 2004, the Company issued 83,333 shares to employees, in connection to its Share Options Schemes (see below), for a total consideration of $9.

c. During 2005, the Company issued 427,404 shares to employees, in connection to its Share Options Schemes (see below), for a total consideration of $132.

Reconciliation of movement in shareholders' Equity

	Share capital	Share Premium Account	Foreign currency translation adjustment	Deficit	Total
As at January 1, 2004	1,177	397,540	16	(314,877)	83,856
Exercise of shares based options by employees(*)	-	9			9
Loss for the year				(12,781)	(12,781)
As at December 31, 2004	1,177	397,549	16	(327,658)	71,084
Exercise of shares based options by employees	1	131			132
Loss for the year				(2,929)	(2,929)
As at December 31, 2005	**1,178**	**397,680**	**16**	**(330,587)**	**68,287**

(*)Less than $1

Notes To The Consolidated Financial Statements

US$ in thousands

Note 20 - Share Capital (Cont.)

Share option schemes

A. General Terms

1. 1996 Share option schemes

In June 1996 the Company has established a Share Option Scheme ("1996 Share option scheme"), which provides for the grant of options and super options, to all eligible directors and employees of the Group or service providers selected by the Board of Directors of the Company ("the eligible employees"). The amount payable for each share is the value, which the Board may, in its absolute discretion, decide, provided that it is not lower than the par value of the share. The aggregate number of unissued shares over which options may be granted under the 1996 Share option scheme on any date of grant is limited to:

a. 5% of the ordinary share capital of the Company then in issue, when aggregated with the number of shares issued and remaining issuable in respect of rights granted (other than super options) within the previous 10 years under the 1996 Share option scheme and any other option scheme operated by the Company or any associated company, or;

b. 10% of the ordinary share capital of the Company then in issue when aggregated with the number of shares issued or remaining issuable in respect of rights granted within the previous 10 years under the scheme or any other option scheme and profit sharing scheme operated by the Company or any associated company.

Any option granted to an eligible employee is limited and takes effect so that the aggregate market value of the shares subject to that option, taken together with the aggregate market value of any other shares which the employee has acquired and which he may acquire on the exercise of any rights granted to him within the previous 10 years to acquire shares under the 1996 Share option scheme and under any other share option scheme operated by the Company or any associated company cannot exceed 8 times his relevant emoluments.

Any option which is not a super option will be limited and take effect so that the aggregate market value of the shares subject to that option must not exceed 4 times the eligible employee's relevant emoluments.

Any super option will be limited and take effect so that the aggregate market value of the shares subject to that option must not exceed 8 times the eligible employee's relevant emoluments.

The exercise of an option may be made subject to the attainment by the Company of a specified level of profits and/or any other objective conditions in relation to the financial performance of the Company, which are considered by the Board to be a fair measure of the performance of the participant.

An option is exercisable in whole or in part, but may not be exercised prior to the expiry of a minimum period, determined by the Board, and not later than the expiry date set by the Board, which shall be no later than the tenth anniversary of the grant of the option, except in the case of super options granted to service providers, which will not be exercisable until 5 years from its grant.

2. 2004 Share option schemes

In November 2004 the Company established a new Share Option Scheme ("2004 Share option scheme"). The Options shall be valid for a period of ten years from the date of grant and thereafter expire. The vesting period pursuant to which options shall vest, and the Grantee thereof shall be entitled to pay for and acquire the exercised shares, shall be such that all options shall be fully vested on the first business day following the passing of three years from the date of grant, as follows: 20% of such options shall vest on the first anniversary of the adoption date, a further 30% on the second anniversary, and 50% on the third anniversary of the adoption date.

Notes To The Consolidated Financial Statements

US$ in thousands

Note 20 - Share Capital (Cont.)

B. Options granted

Since December 1997, the Board of Directors approved the grant of options to certain employees and service providers of the Company. The options generally vest over various periods of three to five years.

The following table summarizes data with respect to the option plans:

	For the year ended December 31,			
	2005		2004	
	Number of share options	Weighted average exercise price	Number of share options	Weighted average exercise price
Outstanding as of beginning of year	8,937,465	£1.1751	10,026,632	£1.2123
Granted	5,546,655	0.1747	1,300,000	0.1748
Exercised	(427,404)	0.1703	(83,333)	0.1025
Forfeited	(666,592)	1.9906	(2,305,834)	0.8116
Outstanding as of end of year	**13,390,124**	0.7522	**8,937,465**	1.1751
Options exercisable as of end of year	**6,665,755**	£1.2536	**5,045,519**	£1.7454

	Outstanding as at December 31, 2005			Exercisable as at December 31, 2005	
Range of exercise prices	Number outstanding	Weighted average remaining contractual life (in years)	Weighted average exercise price	Number exercisable	Weighted average exercise price
NIS 0.01	178,210	4.083	NIS 0.01	178,210	NIS 0.01
£0.1025 - £0.795	11,591,986	7.731	0.1857	4,867,617	0.2142
£1 - £1.705	63,881	4.815	1.1845	63,881	1.1845
£3.725 - £4.4	1,163,547	4.463	4.3490	1,163,547	4.3490
£4.5 - £6.875	392,500	4.609	5.5446	392,500	5.5446
	13,390,124			**6,665,755**	

Weighted Average Grant-Date Fair Value

The weighted average grant-date fair value of the 5,546,655 and 1,300,000 options granted during 2005 and 2004 amounted to £0.17 per option.

Notes To The Consolidated Financial Statements

US$ in thousands

Note 21 - Reconciliation of Net Loss for the Year to Net Cash Used in Operating Activities

	Consolidated	
	Year ended December 31,	
	2005	2004
Loss for the year	(2,929)	(12,781)
Group's share in loss of associated company	-	119
Write-down of an investment	300	-
Amortization of goodwill	2,713	9,898
Depreciation of property, plant and equipment	1,245	1,408
Increase (decrease) in liability of employee termination benefits, net	(4)	17
Gain from selling an Investment in associated company	-	(410)
Loss (gain) from marketable securities	49	(27)
Interest incurred on investments	(390)	(1,627)
Operating cash flow before movements in working capital	984	(3,403)
Decrease (increase) in inventories	(2,283)	258
Increase in receivables	(366)	(1,456)
Increase (decrease) in payables	(427)	2,677
Net cash used in operating activities	**(2,092)**	**(1,924)**

Note 22 - Acquisition of Subsidiary

On July 2005 the Group acquired the net assets of Integral Access Inc, a US corporation, for a cash consideration of $200. The acquisition agreement contains a contingent consideration to be paid by the Company based on the performance of the operations acquired. Based on management estimation at the date of the acquisition, it is probable that the Company will be required to pay an additional amount of $1,140. Accordingly such amount has been included as part of the purchase price paid for the acquired operations and as a liability in this financial statements (see also note 18). Integral Access is involved in next generation access equipment for the delivery of integrated business services by service providers. This transaction has been accounted for by the purchase method of accounting.

Notes To The Consolidated Financial Statements

US$ in thousands

Note 22 - Acquisition of Subsidiary (Cont.)

	Consolidated
	Year ended December 31,
	2005
Net assets acquired	
Property, plant and equipment	443
Inventories	737
Trade and other receivables	649
Trade and other payables	(1,395)
Bank loan	(250)
Other long-term liabilities	(760)
	(576)
Goodwill	1,916
Total consideration	**1,340**
Less-consideration recorded as liability	(1,140)
Total cash consideration	**200**

For the period from January 1, 2005 to July 31, 2005 (date of acquisition) Integral Access' revenues and net loss amounted to $4,800 and $6,400, respectively ($3,474 and profit of $130, respectively for the period from the date of the acquisition to December 31, 2005).

Accordingly, if the results of the operations of Integral Access had been consolidated in to the Group's financial statements starting on January 1, 2005 the Group's consolidated revenues and loss for the year would have been $61,314 and $9,329, respectively.

Note 23 - Analisys of Cash and Cash Equivalents (Consolidated)

Balance at December 31, 2004	**1,153**
Net cash inflow	**17,324**
Balance at December 31, 2005	**18,477**

Note 24 - Commitments and Contigencies

a. Royalties

The Company and one of its subsidiaries are committed to pay royalties to the Office of the Chief Scientist of the Government of Israel ("Chief Scientist") on proceeds from the sale of products for which the Chief Scientist has provided research and development grants. The royalties are up to the amount of 100%-150% of the grants received (in dollar terms). The royalties payable are at a rate of 3%, for the first three years of product sales; 4%, for the following three years, and 5%, thereafter. The total amount of grants received, net of royalties paid or accrued, as at December 31, 2005 was $6,769 (December 31, 2004 - $6,619).

Total royalty expenses to the Chief Scientist for the years ended December 31, 2005 and 2004 were $474 and $341, respectively. These amounts were included in cost of sales.

Notes To The Consolidated Financial Statements

US$ in thousands

Note 24 - Commitments and Contigencies (Cont.)

b. Lease commitments - The Group as lessee

The premises of the Group are rented for various periods through 2011 under operating leases.

	Consolidated	
	Year ended December 31,	
	2005	2004
Minimum lease payments under operating leases recognized in income for the year	1,120	1,124

The total future minimum annual rental payment under the above leases, at rates in effect at December 31, 2005, is as follows:

	Year ended December 31,	
	2005	2004
2005	-	1,140
2006	928	870
2007	557	867
2008	520	867
2009	431	851
2010 and thereafter	754	1,488
Total	3,190	6,083

c. Lease commitments - The Group as lessor

Approximately 50% of the Group's building owned by a subsidiary was leased during 2005 to an unrelated party for $283 (2004: $465)

At the balance sheet date the Group had contracted with tenants for the following future minimum lease payments:

	Consolidated	
	December 31,	
	2005	2004
Within one year	55	297
In the second to fifth years inclusive	88	-
	143	297

Notes To The Consolidated Financial Statements

US$ in thousands

Note 24 - Commitments and Contigencies (Cont.)

d. Stamp duties

There is a potential exposure to the payment of approximately $2 million, representing stamp duties connected with some placements made by the Company in the past. According to the advice of the Company's legal consultants, in contrast to the position of the Companies' Registrar, an obligation to pay stamp duties arises only when a stamped document exists, and since the placements were not accompanied by a stamped issuance report, such obligation does not exist.

The Company has not provided for such an amount in its financial statements.

Note 25 - Material Difference Between Israeli and UK GAAP

The material difference between Israeli and UK GAAP, as applicable to the Group's financial statements, is the accounting treatment with regard to employees share option schemes. Israeli GAAP require the reflection in the financial statements for the difference, if any, at the date of the award, between the fair value of the share and the exercise price of the option starting only from January 1, 2006. Under UK GAAP (FRS 20 "share-based payments") such a difference is charged to the profit and loss account, basically over the vesting period of the options.

Had the Company applied UK GAAP, the loss and the loss per share, for the year ended December 31, 2005, would have increased by $433 and 0.11 cent per share, respectively (2004 – the loss and the loss per share increased by $369 and 0.09 cent per share, respectively).

For purposes of estimating fair value in accordance with FRS 20 "share-based payments", the Company utilized the Black-Scholes options pricing model.

The following assumptions were utilized in such calculation for the years 2005 and 2004
(all in weighted average)

	Consolidated Year ended December 31,	
	2005	2004
Weighted average share price	0.17	0.17
Weighted average exercise price	0.17	0.17
Expected volatility	57-58	56-100
Expected life (in years)	7	7
Risk free rate	4%-4.5%	4%
Expected dividends	-	-

Note 26 - Related Party Transactions

See Notes 5 and 6 with respect to remuneration paid to executive and non-executive directors.

Directors' report

US$ in thousands

Financial Statements

The directors present their report together with the audited financial statements for the year ended 31 December 2005.

Principal Activities and Review of the Business

BATM's main activities are the research and development, production and marketing of data and telecommunication products in the field of local and wide area networks. The operations of the business are reviewed in full in the Chairman's Statement on pages 1-4.

Results and Dividends

The results of the year are set out in the consolidated Income Statements. After providing $4,097 amortization of goodwill for the year, a write down of one of the Company's investments and the cost associated with the early termination of the lease agreement of one of our premises in the US, we recorded a loss of $2,929. No dividend is being declared for the year.

Directors

The following served as Directors during the year:

Peter Sheldon FCA, (64), non-executive Chairman, is a Chartered Accountant and International Business Consultant. He is a former finance director of Hambros Bank and has held positions as Chairman and Director of a number of publicly quoted and private companies. During the year his term of office as Honorary President of a major UK Charity came to an end. His only other commercial appointment is as Non-executive Chairman of Video Domain Technologies Ltd. a private Israeli video security company. He has been a member of the Board of BATM since 1998 and became Chairman in October 1999.

Dr. Dan Kaznelson, M.D., D.M.D. (64), Senior non-executive, is a Physician, a former Lecturer at The Tel-Aviv University, a self-educated Database Systems Analyst and Programmer, and a reserve Colonel in the Israel Defense Forces. He has held positions as Chairman and Director of a number of private and publicly quoted companies. He has been a member of the Board of BATM since 1996 and is at present Chairman of the Audit and Remuneration Committees.

Dr. Zvi Marom (51), Chief Executive Officer, founded BATM in 1992. He holds degrees in Engineering and Medicine. Prior to establishing BATM, he was the head of the Electronic faculty of the Israeli Open University and senior consultant to several industrial and academic institutions. He graduated in excellence from the naval academy and served in combat command posts. He was awarded the Techmark "Technology Man of the Year" award from the London Stock Exchange in 2000. He is currently a director of Shore Capital, a UK company.

Ofer Bar-Ner (41), Chief Financial Officer, joined BATM in 1999. From 1996 he was Chief Financial Officer of Silver Arrow LP, a subsidiary of Elbit Systems and EL-OP, and between 1989 and 1993 he was group manager in the finance Department of Elbit. He graduated in Industrial Engineering and Management from the Technion in Haifa and has an MBA and MA in accounting from Northeastern University in Boston, MA.

Directors' report

Ariella Zochovitzky (49), CPA, non-executive, is the general manager & partner of C.I.G. Capital Investments Group Ltd. She is currently a director of a number of public and private companies in Israel including Pension Funds at Israel Discount Bank Ltd., Scitex Ltd., Inspire Investments Ltd. and Elco Holdings Ltd. She has been a member of the Board of BATM since September 2004.

Koti Gavish (62), non-executive, is the Chief Executive Officer of Eihut Capital Market Ltd. He is currently a director of a number of public and private companies in Israel including Libber Infrastructure Industries Ltd., Pegasus Technologies Ltd., Ampa Ltd., Superior Cables Ltd., Spark Enterprise Ltd and the Provident Funds of Bank Mercantil Discount Ltd. He has been a member of the Board of BATM since September 2004.

Corporate Governance

Compliance

The Board supports the principles of corporate governance outlined in the Combined Code on Corporate Governance (Code). This statement describes the manner in which the Company has applied the principles set out in Section 1 of the code.

The directors consider that throughout the financial year the Company has complied with the requirements of Section 1 of the Code, with the exception of A.1.2 in relation to matters specifically reserved for board decision, and A.1.4 in relation to the Company secretary.

The Board

The Board generally meets every three months. This is in compliance with Israeli company legislation. There is not a formal schedule of matters specifically reserved to the Board for decision, as set out in A.1.2 of the Code, however, provisions in the Israeli company legislation set out the responsibilities and duties of, and areas of decision for, the Board. These provisions have been fully complied with.

The Board comprises six directors, four of whom are non-executive directors, under the chairmanship of Peter Sheldon. The Chief Executive is Dr. Zvi Marom. The senior non-executive director is Dr. Dan Kaznelson. All the directors are of a high calibre and standing. The biographies of all the members of the Board are set out on pages 34&35. Dr. Zvi Marom, Dr. Dan Kaznelson, Peter Sheldon and Ofer Bar-Ner hold shares in the Company and their shareholdings are set out on page 40. All the non-executive directors are independent of management and not involved in any business or other relationship, which could materially interfere with the exercise of their independent judgment.

The induction of newly elected directors into office is the responsibility of the senior independent director (presently Dr. Dan Kaznelson). The new directors receive a memorandum on the responsibilities and liabilities of directors as well as presentations of all activities of the Company by senior members of management and a guided tour of the Company's premises.

The CEO regularly invites all directors to visit the Company premises and its manufacturing facilities. Once per month each director receives a "Flash report" on the Company's activities, and information on the performance of the Company and a report on the trading and quarterly results of the Company are provided at every board meeting. Once per year a budget is discussed and approved by the Board for the following year. All directors are properly briefed on issues arising at Board meetings and any further information requested by a director is always made available.

Under Israeli law it is not a mandatory requirement for a company to have a secretary and the Company does not therefore have a formally appointed secretary. However, Mr. Arthur Moher, who is also one of the Company's legal advisers, provides the Company with all the functions of company secretary and all the directors have access to Mr Moher's services. The directors are therefore of the opinion that the spirit of A.1.4 of the Code has been complied with.

The directors may take independent professional advice at the Company's expense in furtherance of their duties. Independent outside counsel is always present at Board meetings and Board committee meetings.

Corporate Governance

Relations with Shareholders

The Company's management generally meets with the institutional shareholders after the publication of its interim and final financial statements. The Board supports the use of the annual general meeting to communicate with private investors.

Nominations Committee

The Board has a nominations committee which is chaired by Peter Sheldon. Individuals nominated as directors are elected by the shareholders in general meeting. Executive and non-executive directors are elected by the shareholder's General Meeting for a term of one year. Non-executive public "external" directors, as defined by Israeli Company Law are appointed and elected for a mandatory term of three years, which is renewable for a further term of three years. The re-appointment of a director must be approved by the shareholders in general meeting.

Directors' Remuneration

The Board has a Remuneration Committee, which is chaired by Dr. Dan Kaznelson. Information about the service contracts of the executive directors and the remuneration of directors is set out in the Remuneration Report on page 39&40.

Accountability and Audit

Auditors

Brightman Almagor & Co., a member firm of Deloitte Touche Tohmatsu, has expressed its willingness to continue in office and a resolution to re-appoint the firm will be proposed at the annual general meeting.

Audit Committee

The Company has an Audit Committee, which consists of three out of the four non-executive directors, Dr. Dan Kaznelson (Chairman), Mrs. Ariella Zochovitzky and Mr. Koti Gavish.

The Audit Committee meets a minimum of twice a year and the internal and external auditors also attend the meetings. The Audit Committee adheres to the functions and requirements prescribed to it by the Israeli Companies Act and Israeli law. The Chairman of the Audit Committee maintains close contact with the Company on a weekly basis.

The "Market Abuse Directive"

The Board of Directors has established a committee in order to study the draft "Market Abuse Directive" and to supervise the implementation of the guidelines laid down in the "Market Abuse Directive". As of 1 January, 2006 the Company complies with this guidelines, including inter alia, the maintaining of "insiders lists" of all individuals with access to inside information of the Company.

Corporate Governance

Internal Control

The Board of directors has overall responsibility for ensuring that the Company maintains adequate systems of internal control. To this end, in accordance with Israeli Company Law requirements, the Company's Board of Directors appointed Mr. Ezra Yehuda, CPA, as an independent internal auditor, after he was interviewed and recommended by the Audit Committee, as prescribed by Israeli corporate law. The internal auditor reports to the Audit Committee, and is responsible for ensuring that the Company is run according to good corporate practice.

Risk management is currently reviewed on an ongoing basis by the Board as a whole.
The key features of the financial controls of the Company include a comprehensive system of financial reporting, budgeting and forecasting, and clearly laid down accounting policies and procedures. The Board of the Company is furnished with detailed financial information on a monthly basis.

Statement of Directors' Responsibilities

After making enquiries, the Directors have a reasonable expectation that the Company and its subsidiaries have adequate resources to continue in operational existence for the foreseeable future. For this reason, they have adopted the going concern basis in preparing the financial statements.

Company law requires the Directors to prepare financial statements for each financial period, which give a true and fair view of the state of affairs of the Company and the group, and of the profit and loss of the group for the period. In preparing these financial statements, the Directors are required to: select suitable accounting policies and then apply them consistently; make judgments and estimates that are reasonable and prudent; state whether applicable accounting standards have been followed, subject to any material departures disclosed and explained in the financial statements; and prepare the financial statements on the going concern basis unless it is inappropriate to presume that the group will continue in business.

The Directors are responsible for keeping proper accounting records which disclose with reasonable accuracy at any time the financial position of the group and to ensure that the financial statements comply with the Companies Act 1985. They are also responsible for safeguarding the assets of the group and hence for taking reasonable steps for the prevention and detection of fraud and other irregularities.

Environmental Policy

The Directors recognize the importance of the Group adhering to clear environmental objectives.

The Company's environmental policy is to:

- Meet the statutory requirements placed on it;
- Adopt good environmental practice in respect of premises, product development and manufacturing, and consumption of resources;
- Aim to recycle as much of its waste products as it is economically practicable to do.

The Company has begun implementing the recommendations of ROHS (The Restriction of Hazardous Substances in Electrical and Electronic Equipment (ROHS) Directive (2002/95/EC), and as from year 2006, all its products will be fully ROHS compatible.

Directors' Remuneration

US$ in thousands

Remuneration Committee and Remuneration Report

The remuneration committee consists of three out of the four non-executive directors. As presently constituted, the committee consists of Dr. Dan Kaznelson, Mrs Ariella Zochovitzky and Mr Koti Gavish. Dr. Dan Kaznelson serves as chairman. The committee is responsible for recommendation to the board of the remuneration strategy and policy of the Company for determining the short and long-term incentive pay structures for the executive directors. With the exception of the "public external" non-executive directors who serve for a period of three years in accordance with Israeli Company law, all directors have to be re-elected by the shareholders at AGM, if proposed for re-election.

In accordance with Israeli company law, the Board recommends and the general meeting of the Company is asked to approve, the remuneration of the executive and non-executive directors of the Company, after it has been first approved by the Company's Remuneration Committee. The remuneration of the executive and non-executive directors of the Company for the year ended 31 December 2005 was as follows:

Executive Directors in 2005

Dr. Zvi Marom - CEO - earned a basic salary of $200 and social benefits as are normally granted by employers in Israel. An annual profit share bonus, based on the rate of increase in net profit of each year, is also payable, the terms having been approved at the Company's last AGM on 25, May 2005. No bonus was payable in respect of 2004 under this plan.

Ofer Bar-Ner - CFO - earned a basic salary of $80 per year plus social benefits. During the course of the year, no salary was paid to him during a three month period when he took a leave of absence from the Company. His current salary and benefits are considerably less than the 2004 level when he was relocated by the Company to Boston and received a US based salary.

	2005	2004
	Salary and Benefits	Salary and Benefits
Dr. Zvi Marom	270	263
Ofer Bar-Ner	78	356

Non-Executive Directors in 2005

The non-executive Chairman is remunerated at a rate of $18 per annum, plus $3 for each Board or other meeting attended. Dr. Dan Kaznelson is paid $9 per annum and $1.5 per meeting respectively. Mrs. Ariella Zochovitzky and Mr. Koti Gavish, the public external directors, were remunerated in accordance with Israeli Company Law provisions for such appointees. In addition they received a remuneration package of 200,000 share options each per annum, which was approved by the Company's audit & remuneration commitee and board of directors and was subsequently approved by the Shareholders Annual Meeting at the time of their election as directors.

The Chairman's remuneration reflects both his responsibility and the fact that, as a resident of the UK, he has to travel to Israel for board meetings. These fees were arrived at by reference to fees paid by other companies of similar size and complexity and reflected the amount of time that non-executive directors are expected to devote to the Company's activities during the year.

Directors' Remuneration

US$ in thousands

	2005 Fees	2004 Fees
Peter Sheldon	38	36
Dr. Dan Kaznelson	18	15
Daniel Goldman	3	15
Ariella Zochovitzky	10	2
Koti Gavish	10	2

Directors' Interest in Shares

The directors of the Company are listed below together with their beneficial interests in the shares of the Company at the beginning and end of the financial year.

	0.01 NIS Ordinary Shares fully paid 2005	0.01 NIS Ordinary Shares fully paid 2004
Dr. Zvi Marom	91,750,900	101,750,900
Dr. Dan Kaznelson	135,300	135,300
Peter Sheldon	100,000	100,000
Ofer Bar-Ner	58,600	58,600

Directors' Options (Accumulated)

	Number of options 2005	Number of options 2004
Dr. Zvi Marom *	2,700,000	700,000
Ofer Bar-Ner **	333,333	333,333
Ariella Zochovitzky	400,000	200,000
Koti Gavish	400,000	200,000

* The grant is of :

a. 400,000 options exercisable into 100,000 ordinary shares of the Company per year commencing on July 1, 2000 and on July 1, of every subsequent year. Each option vests and is exercisable 24 months from the date of each grant, at a price equal to the then current market price less ten per cent.

b. The 300,000 options granted at an exercise price of £0.20 per share these options will vest at a rate of 100,000 options annually on July 1st of each year commencing from July 1, 2004.

c. 2,000,000 options granted as follows: one million at an exercise price of £0.1625 per share these options will vest over 3 years commencing from December 31, 2005. The additional one million are performance linked incentive provided that the annual net profit of the Company has increased by at least 15% as compared with the previous year and that the Company has made a net profit in the relevant financial year, the exercise price is £0.1625 per share and will vest over 3 years commencing from December 31, 2005.

** The options vested fully on January 1, 2004 at exercise price of £0.2648.

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