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Management's Discussion and Analysis

The following management's discussion and analysis of financial condition and results of operations should be read in conjunction with our financial statements and notes thereto. Certain matters discussed below and throughout this annual report are forward-looking statements that are based on our beliefs and assumptions as well as information currently available to us. Such forward-looking statements may be identified by the use of the words "anticipate","project","believe","estimate","expect","plan" and similar expressions. One can also identify them by the fact that they do not relate strictly to historical or current facts. Such statements reflect our current views and assumptions with respect to future events and are subject to certain risks and uncertainties. Should one or more of the underlying assumptions prove incorrect, or these risks and uncertainties materialize, our actual results may differ materially from those described herein. Please read the section below entitled "Factors That May Affect Future Results" to review conditions that we believe could cause actual results to differ materially from those contemplated by the forward-looking statements. These and other risks and uncertainties are described herein or in the Company's other public documents. Readers are cautioned not to place undue reliance on these forward-looking statements, which speak only as of the date hereof. We undertake no obligation to update these forward-looking statements to reflect events or circumstances after the date hereof or to reflect the occurrence of unanticipated events.

Results of Operations

Revenues. Revenues increased 30% in 2000 to $153.2 million from $117.4 million in 1999, and $91.0 million in 1998. Sales of the Company's CTI and quality management (CEM) products rose 25% in 2000 and represented 84% of total sales; sales of digital video products increased approximately 180% and represented 10% of total revenues, and revenues from sales of COMINT systems remained unchanged and accounted for 6% of total sales. On a geographical basis, 2000 sales in North America, Europe (including Israel) and the rest of the world increased 40%, 0%, and 69%, respectively. On a percentage of total revenue basis, 2000 sales in North America represented 53% compared with 50% in 1999; Europe 26% versus 34%, and the rest of the world, 21% compared with 16%. We expect that sales in Europe and the rest of the world will represent a growing portion of our total revenues due mainly to the planned expansion of our field operations in Europe and the Far East.

Gross Profit. Gross profit increased 17% in 2000 to $78.4 million from $67.2 million in 1999, and $52.2 million in 1998. Gross profit margin was 51.2%, 57.3% and 57.4% in 2000, 1999 and 1998, respectively. The decline in gross profit margin in 2000 is due primarily to the higher relative proportion of sales of digital video products and COMINT systems, which tend to have lower gross margins than CEM products, pricing and higher provisions for inventory. We believe that gross margins may decline in the future due to heightened competitive pressures on pricing of products, a higher proportion of comparatively lower margin products in the sales mix and increases in manufacturing costs of certain products.

Research and Development. Research and development expense, before capitalization of software development costs and grants, increased 64% in 2000 to $27.4 million from $16.7 million in 1999, and $12.7 million in 1998. Net research and development expense rose 56% in 2000 to $21.5 million from $13.8 million in 1999, and $10.8 million in 1998. As a percent of revenues, net research and development expense was 14%, 12% and 12% in 2000, 1999 and 1998, respectively.

The increase in net research and development expense is due principally to higher average labor costs reflecting the highly competitive market for engineers as well as a 24% increase in the number of R&D personnel. The increase in R&D personnel was due mainly to the development and support of new products for each of our product lines. We believe that a significant level of investment for research and development is essential for us to maintain market leadership and to achieve our long-term business objectives. Accordingly, we anticipate that we will continue to invest significant resources in research and development due mainly to the development of additional applications for our Customer Experience Management platform, new digital video technologies and additional COMINT product offerings. However, there can be no assurance that these development efforts will be successful or will not be rendered obsolete by future technology developments or acquisitions or be abandoned due to changes in strategic direction.

Software development costs capitalized were $4.7 million in 2000 compared with $2.6 million in 1999, and $1.9 million in 1998. Amortization of capitalized software development costs, included in cost of products, was $1.6 million in 2000 compared with $1.1 million in 1999 and $0.3 million in 1998.

Selling and Marketing Expenses. Selling and marketing expenses increased 42% to $48.7 million in 2000 from $34.3 million in 1999, and $26.7 million in 1998. The increase in selling and marketing expenses in 2000 is due principally to the creation of separate sales and marketing infrastructures for our CEM platform, digital video products and COMINT systems and increased promotional activities related to the launch of the CEM concept and platform. We believe that selling and marketing expenses will increase at a slower rate in the future as the expansion of operations in Europe and in the Far East will be offset, in large measure, by a reduction in workforce related to a strategic organizational change and lower outlays for promotional activities. However, there can be no assurance that the organizational change and lower spending on marketing activities will not have a detrimental impact on revenue growth or will reduce the rate of increase in selling and marketing expenses.

General and Administrative Expenses. General and administrative expenses increased 61% to $12.7 million in 2000 from $7.9 million in 1999, and $6.7 million in 1998. The increase in general and administrative expenses is due primarily to higher outlays for improvements to various management information systems and an increase in the provision for doubtful accounts.

Other Special Charges. In 2000, the Company recorded a charge of $6.8 million related to in-process research and development of software acquired in the CenterPoint Solutions, Inc. transaction for which technological feasibility has not yet been established and for which no alternative future use exists. In 1999, the Company recorded a charge of $5.2 million to write-off certain items, including in-process research and development of software, arising in the acquisition of STS Software Systems Ltd. In 1998, the Company recorded a charge of approximately $9.0 million to write-off certain assets and liabilities, including in-process research and development of software, related to the acquisition of International Blue Software Corp. and to the Company's relocation to new premises.

Operating Income (Loss). Operating loss was $11.3 million in 2000 compared with operating income of $6.1 million in 1999 and an operating loss of $1.0 million in 1998.

Financial Income, net. Financial income, net increased 29% to $6.2 million from $4.8 million in 1999, and $5.8 million in 1998. The increase in 2000 is due primarily to higher average interest rates on cash balances. We expect that net financial income will decline in the future due principally to lower expected average cash balances and market interest rates.

Liquidity and Capital Resources

Cash, cash equivalents and short-term deposits at the end of 2000 were $43.0 million compared with $66.5 million in 1999 and $74.5 million in 1998. Marketable securities and other long-term cash investments totaled $55.0 million, $48.0 million and $29.2 million in 2000, 1999 and 1998, respectively.

Net cash used in operations in 2000 was $2.1 million compared with net cash provided by operations of $19.6 million in 1999 and $8.3 million in 1998. The decrease in 2000 is due mainly to the net loss, increase in trade receivables and increase in inventories.

Net cash used in investing activities was $18.1 million in 2000, $35.1 million in 1999 and $25.7 million in 1998. Capital expenditures, which totaled $14.2 million in 2000, included investments in software and computer systems for research and development purposes, management information systems and self-made equipment for demonstration and research and development purposes.

Net cash from financing activities in 2000 totaled $15.0 million compared with $10.3 million in 1999 and $1.1 million in 1998. The increase in 2000 is due mainly to proceeds from the exercise of employee stock options.

We believe that available working capital will be sufficient to meet our operating requirements. Depending upon our future growth, the success of our business initiatives and acquisition opportunities, we will consider from time to time various financing alternatives and may seek to raise additional capital to finance our strategic efforts through debt or equity financing or to enter into strategic arrangements.

Qualitative and Quantitative Disclosure About Market Risk

Market risks relating to our operations result primarily from weak economic conditions in the markets in which we sell our products and changes in interest rates and exchange rates. To manage the volatility related to the latter exposure, we may enter into various derivative transactions. Our objective is to reduce, where it is deemed appropriate to do so, fluctuations in earnings and cash flows associated with changes in currency exchange rates. It is our policy and practice to use derivative financial instruments only to manage exposures. We do not use financial instruments for trading purposes and are not a party to any leveraged derivative.

Foreign Currency Risk. We conduct our business primarily in U.S. dollars but also in the currencies of the United Kingdom, Canada, Germany and Israel. Thus, we are exposed to foreign exchange movements, primarily in European and Israel currencies. We monitor foreign currency exposure and, from time to time, may enter into various contracts to preserve the value of sales transactions and commitments.

U.S. dollars (in Millions)	2001	2002-05	Total
Forward contracts to sell U.S. dollars for foreign currencies			
Israel Shekels			
Notional Value	$ 12.5	–	$ 12.5
Average Contract Rate	4.13	–	
Forward contracts to buy U.S. dollars for foreign currencies			
Israel Shekels			
Notional Value	$ 2.0	–	$ 2.0
Average Contract Rate	4.11	–	

Factors That May Affect Future Results

We operate globally in a dynamic and changing environment that involves numerous risks and uncertainties. The following section lists some, but not all, of those risks and uncertainties that could cause actual results and outcomes to differ materially from those contained in any forward-looking statement made by or on behalf of the Company.

The sales cycle for our solutions is variable, typically ranging between a few weeks to several months from initial contact with the potential client to the signing of a contract. Occasionally sales require substantially more time. Delays in executing client contracts may affect our revenue and cause our operating results to vary widely. Any delays in payment or in the achievement of milestones may have a material adverse impact on our financial position.

As a high percentage of our expenses, particularly employee compensation, is relatively fixed, a variation in the level of sales, timing of the initiation, progress or completion of projects or engagements, especially at or near the end of any quarter, may have a material adverse impact on our quarterly operating results.

The market for our products and related services, in general, is highly competitive. Additionally, some of our principal competitors have significantly greater resources than do we. Price reductions or declines in demand for our products and services, whether as a result of competition, weak economic conditions, market-related issues or technological change, would have a material adverse effect on our results of operations and financial position.

Variations in our revenue and operating results could occur as a result of a number of other factors, such as the budgeting and purchasing practices of our customers, the length of the customer product evaluation process, the timing and cost of new product introductions and product enhancements, availability of components and the timing of any acquisitions and associated costs.

Variations in sales channels, product costs or mix of products sold, changes in exchange rates and general economic conditions in our geographic areas of operation could also have a material adverse impact on operations and financial results. Additional factors that may cause actual results to differ materially from our expectations include our ability to manage expense levels, the continued financial strength of our customers, dealers and distributors, the ability to offer financing vehicles to our customers and the ability to manage accounts receivable.

The operating results of many technology companies reflect seasonal trends, and we expect to be affected by such trends in the future. Although we have not experienced consistent seasonal fluctuations in operational results to date, we believe that it is likely that we will experience relatively higher revenues in the fourth quarter and relatively lower revenues in the first quarter due mainly to customers' annual purchasing and budgetary practices.

We have experienced significant annual increases in revenue since 1994. This growth has placed, and if it continues will place, a significant strain on the Company's management, operations and resources. To accommodate our recent growth and global expansion, we are implementing a variety of new or expanded business systems, procedures and controls. There can be no assurance that the implementation of such systems, procedures, controls and other internal systems can be completed successfully. If our growth continues, we will be required to hire and integrate new employees. There can be no assurance that we will be able to successfully recruit and integrate new employees. Competition for highly skilled employees, including sales, technical and management personnel, is high in the technology industry. Our failure to manage growth effectively, including our failure to attract talented employees or retain the services of key personnel, could have a material adverse effect on our results of operations and financial position.

As part of our growth strategy, we may, from time to time, acquire or invest in complementary businesses, products or technologies. We frequently evaluate the tactical or strategic opportunity available related to complementary businesses, products or technologies. The process of integrating an acquired company's business into our operations and/or of investing in new technologies, may result in unforeseen operating difficulties and large expenditures and may absorb significant management attention that would otherwise be available for the ongoing development of our business. Moreover, there can be no assurance that the anticipated benefits of any acquisition or investment will be realized. Future acquisitions or investments contemplated and/or consummated could result in potentially dilutive issuances of equity securities, the incurrence of debt and contingent liabilities, amortization expenses related to goodwill and other intangible assets, any of which could have a material adverse effect on our operating results and financial condition.

We have also invested in companies, which can still be considered in the start-up or development stages. These investments are inherently risky as the market for the technologies or products they have under development are typically in the early stages and may never materialize. We could lose our entire initial investment in these companies.

Additional factors that may cause actual results to differ materially from our expectations include industry specific factors; our ability to continuously develop, introduce and deliver commercially viable products, solutions and technologies, and the market's rate of acceptance of the solutions we offer; our ability to keep pace with market and technology changes and to compete successfully, and our ability to manage the competitive risks associated with the strategic alliances that we have entered into.

Our products focus specifically on organizations' business-critical operations. The provisions of our sales contracts limit our exposure to potential liability claims. Although we carry product liability and errors and omissions insurance against such claims, there can be no assurance that such insurance will continue to be available on acceptable terms, if at all, or that such insurance will provide us with adequate protection against any such claims. A significant liability claim against us could have a material adverse effect on our results of operations and financial position.

Subsequent to the Company's restatement of its 1999 financial results in February 2001, a number of class action lawsuits have been filed against the Company and certain current or former officers or directors of the Company (see Note 10, "Commitments and Contingent Liabilities" in the accompanying consolidated financial statements). The Company does not believe it is feasible to predict or determine the outcome or resolution of these proceedings, or to estimate the amount of, or potential range of, loss with respect to these proceedings. In addition, the timing of the final resolution of these proceedings is uncertain. The range of possible resolutions of these proceedings could include judgments against the Company or settlements that could require substantial payments by the Company which could cause it to incur material losses.

Report of Independent Auditors

To The Shareholders of NICE Systems Ltd.

We have audited the accompanying consolidated balance sheets of NICE Systems Ltd. ("the Company") and subsidiaries as of December 31, 1999 and 2000 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, 2000. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

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

In our opinion, the consolidated financial statements referred to above, present fairly, in all material respects, the consolidated financial position of the Company and its subsidiaries as of December 31, 1999 and 2000, and the consolidated results of their operations and cash flows for each of the three years in the period ended December 31, 2000, in conformity with accounting principles generally accepted in the United States.

Kost Forer & Gabbay

KOST FORER & GABBAY
A Member of Ernst & Young International

Tel-Aviv, Israel
February 26, 2001

Consolidated Balance Sheets

U.S. dollars in thousands

December 31	1999	2000
ASSETS		
CURRENT ASSETS:		
Cash and cash equivalents	$ 23,833	$ 18,640
Short-term bank deposits	42,623	24,371
Marketable securities (Note 3)	30,459	29,089
Trade receivables (net of allowance for doubtful accounts of $1,092 and $3,783 in 1999 and 2000, respectively)	38,741	46,367
Unbilled receivables	2,172	1,816
Other receivables and prepaid expenses (Note 4)	6,510	11,994
Inventories (Note 5)	10,774	21,159
Total current assets	155,112	153,436
LONG-TERM INVESTMENTS:		
Long-term marketable securities (Note 3)	17,495	25,916
Investment in affiliates (Note 6)	229	1,429
Severance pay fund	4,018	5,011
Long-term prepaid expenses	138	20
Total long-term assets	21,880	32,376
PROPERTY AND EQUIPMENT, NET (Note 7)	19,992	25,896
OTHER ASSETS, NET (Note 8)	9,038	39,781
Total assets	$ 206,022	$ 251,489

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

Consolidated Balance Sheets

U.S. dollars in thousands (except per share data)

December 31	1999	2000
LIABILITIES AND SHAREHOLDERS' EQUITY		
CURRENT LIABILITIES:		
Short-term bank credit	$ 3	$ –
Trade payables	11,201	12,650
Accrued expenses and other liabilities (Note 9)	10,510	23,467
Total current liabilities	21,714	36,117
LONG-TERM LIABILITIES:		
Deferred lease payments	418	247
Accrued severance pay	4,700	6,527
Other long-term liabilities	120	21
Total long-term liabilities	5,238	6,795
COMMITMENTS AND CONTINGENT LIABILITIES (Note 10)		
SHAREHOLDERS' EQUITY:		
Share capital (Note 12)		
Authorized: 50,000,000 ordinary shares of NIS 1.00 par value, as of December 31, 1999 and 2000;		
Issued and outstanding: 11,881,137 shares and 12,914,680 shares as of December 31, 1999 and 2000, respectively	4,062	4,313
Additional paid-in capital	153,160	187,679
Deferred stock compensation	(103)	(47)
Retained earnings	21,951	16,632
Total shareholders' equity	179,070	208,577
Total liabilities and shareholders' equity	$ 206,022	$ 251,489

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

Consolidated Statements Of Operations

U.S. dollars in thousands (except per share amounts)

Year ended December 31	1998	1999	2000
Revenues (Note 13)	$ 90,970	$ 117,411	$ 153,163
Cost of revenues	38,735	50,184	74,802
Gross profit	52,235	67,227	78,361
Operating expenses:			
Research and development, net (Note 14a)	10,751	13,825	21,498
Selling and marketing	26,700	34,296	48,713
General and administrative	6,727	7,855	12,651
Other special charges (Note 14c)	9,023	5,155	6,786
Total operating expenses	53,201	61,131	89,648
Operating income (loss)	(966)	6,096	(11,287)
Financial income, net (Note 14b)	5,792	4,809	6,188
Other income (expenses), net	–	(4)	53
Income (loss) before taxes on income	4,826	10,901	(5,046)
Taxes on income (Note 11)	347	74	273
Net income (loss)	$ 4,479	$ 10,827	$ (5,319)
Basic earnings (loss) per share (Note 14e)	$ 0.40	$ 0.94	$ (0.43)
Diluted earnings (loss) per share (Note 14e)	$ 0.37	$ 0.88	$ (0.43)

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

Statements Of Changes In Shareholders' Equity

U.S. dollars in thousands

	Share capital	Additional paid-in capital	Deferred stock compensation	Retained earnings	Total shareholders' equity
Balance as of January 1, 1998	$ 3,860	$ 139,128	$ (603)	$ 6,645	$ 149,030
Issuance of shares in respect of the acquisition of IBS	10	1,390	–	–	1,400
Amortization of deferred stock compensation	–	–	293	–	293
Exercise of stock options	49	1,956	–	–	2,005
Net income	–	–	–	4,479	4,479
Balance as of December 31, 1998	3,919	142,474	(310)	11,124	157,207
Issuance of warrants in respect of the acquisition of STS	–	229	–	–	229
Amortization of deferred stock compensation	–	–	207	–	207
Exercise of stock options	143	10,457	–	–	10,600
Net income	–	–	–	10,827	10,827
Balance as of December 31, 1999	4,062	153,160	(103)	21,951	179,070
Issuance of shares in respect of the acquisition of CPS	37	9,349	–	–	9,386
Issuance of shares in respect of ESPP options	7	934	–	–	941
Deferred stock compensation	–	72	(72)	–	–
Issuance of shares in respect of the acquisition of SCI	54	10,267	–	–	10,321
Amortization of deferred stock compensation	–	–	128	–	128
Exercise of stock options and warrants	153	13,897	–	–	14,050
Net loss	–	–	–	(5,319)	(5,319)
Balance as of December 31, 2000	$ 4,313	$ 187,679	$ (47)	$ 16,632	$ 208,577

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

Consolidated Statements Of Cash Flows

U.S. dollars in thousands

Year ended December 31	1998	1999	2000
Cash flows from operating activities:			
Net income (loss)	$ 4,479	$ 10,827	$ (5,319)
Adjustments required to reconcile net income (loss) to net cash provided by (used in) operating activities:			
Depreciation and amortization	4,544	6,798	11,725
Property and equipment write-off in respect of relocation of offices	1,698	–	–
In-process research and development write-off in respect of CPS acquisition	–	–	6,786
In-process research and development write-off in respect of IBS acquisition	6,263	–	–
In-process research and development write-off in respect of STS acquisition	–	5,155	–
Amortization of deferred stock compensation	293	207	128
Accrued severance pay, net	94	367	899
Loss (gain) on available-for-sale marketable securities, amortization of (premium) discount and accrued interest on held-to-maturity marketable securities	(14)	62	(345)
Increase in trade and unbilled receivables	(10,750)	(1,565)	(12,968)
Decrease (increase) in other receivables and prepaid expenses	647	(2,414)	(82)
Increase in inventories	(2,948)	(2,243)	(10,006)
Increase in long-term prepaid expenses	–	(138)	–
Increase in trade payables	1,449	2,730	1,438
Increase (decrease) in accrued expenses and other liabilities	2,628	(33)	5,729
Other	(54)	(127)	(53)
Net cash provided by (used in) operating activities	8,329	19,626	(2,068)

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

Consolidated Statements Of Cash Flows

U.S. dollars in thousands

Year ended December 31	1998	1999	2000
Cash flows from investing activities:			
Purchase of property and equipment	(9,257)	(10,062)	(14,161)
Purchase of other assets	–	(175)	–
Investment in held-to-maturity marketable securities	(22,595)	(22,389)	(1,467)
Proceeds from maturity of held-to-maturity marketable securities	11,052	17,064	38,525
Investment in available-for-sale marketable securities	(383)	–	–
Proceeds from sale of available-for-sale marketable securities	384	269	–
Proceeds from sale of short-term bank deposits	60,735	69,469	49,454
Investment in long-term held-to-maturity marketable securities	(10,569)	(13,984)	(43,671)
Investment in affiliates	(101)	–	(1,200)
Payment for acquisition of IBS (a)	(4,446)	–	–
Payment for acquisition of STS (b)	–	(6,267)	–
Payment for acquisition of CPS (c)	–	–	(3,189)
Payment for acquisition of assets and liabilities of SCI (d)	–	–	(6,960)
Investment in short-term bank deposits	(48,953)	(66,601)	(31,028)
Proceeds from sale of property and equipment	409	151	394
Capitalization of software development costs	(1,930)	(2,570)	(4,730)
Other	(40)	–	(80)
Net cash used in investing activities	(25,694)	(35,095)	(18,113)
Cash flows from financing activities:			
Proceeds from issuance of shares and exercise of stock options and warrants, net	2,005	10,600	14,991
Short-term bank credit, net	(883)	(303)	(3)
Net cash provided by financing activities	1,122	10,297	14,988
Decrease in cash and cash equivalents	(16,243)	(5,172)	(5,193)
Cash and cash equivalents at the beginning of the year	45,248	29,005	23,833
Cash and cash equivalents at the end of the year	$ 29,005	$ 23,833	$ 18,640

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

Consolidated Statements Of Cash Flows

U.S. dollars in thousands

Year ended December 31	1998	1999	2000
Supplemental disclosure of cash flows activities:			
Cash paid during the year for:			
Income taxes	$ 207	$ 58	$ 105
(a) Payment for acquisition of IBS:			
Estimated fair value of assets acquired and liabilities assumed at the date of acquisition:			
Working capital deficiency	$ (466)		
Property and equipment	49		
In-process research and development	6,263		
	5,846		
Less - amount acquired by issuance of shares	(1,400)		
	$ 4,446		
(b) Payment for acquisition of STS:			
Estimated fair value of assets acquired and liabilities assumed at the date of acquisition:			
Working capital deficiency (excluding cash and cash equivalents)		$ (875)	
Property and equipment		90	
In-process research and development		5,155	
Assembled work-force		287	
Other long-term liabilities		(152)	
Goodwill		1,991	
		6,496	
Less - amount acquired by issuance of warrants		(229)	
		$ 6,267	

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

Consolidated Statements Of Cash Flows

U.S. dollars in thousands

Year ended December 31	1998	1999	2000
(c) Payment for acquisition of CPS			
Estimated fair value of assets acquired and liabilities assumed at the date of acquisition:			
Working capital (excluding cash and cash equivalents)			$ 158
Property and equipment			185
Long-term investments			93
Long-term liabilities			(42)
In-process research and development			6,786
Core technology			2,189
Assembled work-force			409
Goodwill			2,797
			12,575
Less - amount acquired by issuance of shares			(9,386)
			$ 3,189
(d) Payment for acquisition of certain assets and liabilities of SCI:			
Estimated fair value of assets acquired and liabilities assumed at the date of acquisition:			
Working capital deficiency			$ (6,881)
Assembled work-force			523
Goodwill			23,639
			17,281
Less - amount acquired by issuance of shares			(10,321)
			$ 6,960

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

Note 1. GENERAL

a. NICE Systems Ltd. ("NICE") and its subsidiaries (collectively "the Company") develop, design, manufacture and market products for integrated multimedia digital recording (audio, video and data), quality management software solutions and communication intelligence systems and provide related professional services.

Our Customer Experience Management, or CEM, solutions help customers improve their businesses by effectively capturing, evaluating and analyzing voice communications, internet collaboration, VoIP, call data, desktop screens, email storage and video. Our products are part of the CEM market space, which is an extension of the broader CTI (Computer Telephony Integration) and CRM (Customer Relationship Management) market. Our digital video solutions are used by security organizations to record and archive digital video and audio for debriefing and investigative applications. We also provide communication intelligence, or COMINT, systems that are used primarily by government agencies to detect, identify, locate, monitor and record transmissions from a variety of sources.

We serve the business needs of multiple markets, primarily customer contact centers (formerly called call centers), financial institutions, air traffic control sites, public safety centers, closed circuit television security installations and government agencies

The Company depends on a limited number of suppliers and on a single supplier for some components and subassemblies for its systems. If such suppliers fail to deliver the necessary components, the Company may be required to seek alternative sources of supply. Although the Company generally maintains an inventory of components to limit the potential for interruption of a supplier's ability to provide components to the Company, a change in suppliers 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.

The Company relies upon a limited number of independent dealers to market, sell and service its products in certain markets. If the Company is unable to effectively manage and maintain relationships with its dealers, or to enter into similar relationships with others, its ability to market and sell its products in certain markets will be affected. In addition, a loss of a major dealer, or any event negatively affecting such dealer's financial condition, could cause a material adverse effect on the Company's results of operations and financial position.

As for major customer data, see Note 13c.

b. Acquisition of International Blue Software Corp.:

In April 1998, the Company purchased the assets and assumed the liabilities of International Blue Software Corp. ("IBS") for an aggregate consideration of $ 6,000 including the issuance of 35,110 ADSs of NICE. The acquisition was accounted for as a purchase and accordingly, the purchase price has been allocated according to the fair value of the assets acquired and liabilities assumed of IBS.

IBS provided remote control, monitoring and training solutions for call centers.

In connection with the IBS acquisition the Company recorded, in the second quarter of 1998, a one-time expense of approximately $ 6,263 to write-off software acquired from IBS, for which technological feasibility has not yet been established and for which no alternative future use exists.

The Company recorded an additional expense in the amount of $ 500 for reorganization costs, due to employee termination costs resulting from the acquisition of IBS.

Pro forma information in accordance with APB 16 has not been provided as the revenues of IBS for 1998 were not material in relation to total consolidated revenues and net income.

c. Acquisition of STS Software System (1993) Ltd.:

In December 1999, the Company acquired all the outstanding capital stock of STS Software Systems (1993) Ltd. ("STS") for an aggregate consideration of $ 6,496 including 50,000 warrants of NICE with an exercise price of $40 per share. The acquisition was accounted for as a purchase and accordingly, the purchase price has been allocated according to the fair value of the assets acquired and liabilities assumed of STS.

STS is a developer of complete digital multimedia logging solutions for information media, including technology for recording information from the Internet with an advanced VoIP (Voice over Internet Protocol) interface.

In connection with the STS acquisition the Company recorded, in the fourth quarter of 1999, a one-time expense of $ 5,155 to write-off software acquired from STS for which technological feasibility has not yet been established and for which no alternative future use exists. An amount of $2,278, out of the total acquisition cost, was attributed to goodwill and other intangible assets and is being amortized over their estimated useful lives.

The following represents the unaudited pro forma results of operations for the years ended December 31, 1998 and 1999, assuming that the acquisition occurred on January 1, 1998 and January 1, 1999, respectively:

Year ended December 31	1998	1999
Revenues	$ 92,403	$ 118,024
Net income	$ 4,472	$ 9,813
Basic earnings per share	$ 0.40	$ 0.85
Diluted earnings per share	$ 0.37	$ 0.80

d. Acquisition of CenterPoint Solutions Inc.:

In April 2000, the Company acquired all of the outstanding capital stock of CenterPoint Solutions Inc. ("CPS") for a total consideration of $ 12,886 including the issuance of 150,000 ADSs of NICE. The acquisition was accounted for as a purchase and accordingly, the purchase price has been allocated according to the fair value of the assets acquired and liabilities assumed of CPS.

CPS is a developer of Internet-based applications for statistical monitoring, digital recording and automatic customer surveys for call centers.

In connection with the CPS acquisition the Company recorded, in the second quarter of 2000, a one-time expense of $ 6,786 to write-off software acquired from CPS for which technological feasibility has not yet been established and for which no alternative future use exists. An amount of $ 5,395 out of the total acquisition cost was attributed to goodwill and other intangible assets and is being amortized over their estimated useful lives.

Pro forma information in accordance with APB 16 has not been provided as the revenues of CPS for 1999 and 2000 were not material in relation to total consolidated revenues and net income.

e. Acquisition of Stevens Communications Inc.:

In December 2000, the Company acquired certain assets and assumed certain liabilities of Stevens Communications Inc. ("SCI") for an aggregate consideration of $ 18,931 including the issuance of up to 426,745 ADSs of NICE of which 186,818 ADSs are target shares contingent upon the achievement of certain objectives and events through 2002 and 38,914 ADSs are for the benefit of certain Stevens' employees. The acquisition was accounted for as a purchase and accordingly, the purchase price has been allocated according to the fair value of the assets acquired and liabilities assumed of SCI.

SCI is a systems distributor, whose activities included the promotion, distribution, installation and maintenance of the Company's products in North America.

An amount of $ 24,162, out of the total acquisition cost, was attributed to goodwill and other intangible assets and is being amortized over their estimated useful lives.

The Company is currently involved in a dispute with SCI regarding the fair value of SCI's working capital. If the dispute is not resolved in the Company's favor, it may stand to lose a significant amount of receivables, to which the Company believes it is entitled.

Note 2. SIGNIFICANT ACCOUNTING POLICIES

The consolidated financial statements were prepared in accordance with United States Generally Accepted Accounting Principles ("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 effect the amounts reported in the financial statements and accompanying notes. Actual results could differ from those estimates.

b. Financial statements in United States dollars:

The currency of the primary economic environment in which the operations of the Company are conducted is the U.S. dollar ("dollar"); thus, the dollar is the reporting and functional currency of the Company and most of its subsidiaries. For the Company and those subsidiaries whose functional currency is the dollar, transactions and balances denominated in dollars are presented at their original amounts. Gains and losses arising from non-dollar transactions and balances are included in net financial income.

The Company's transactions and balances denominated in U.S. dollars are represented at their original amounts. Non-dollar transactions and balances have been remeasured to U.S. dollars in accordance with Statement of Financial Accounting Standards ("SFAS") No. 52 - "Foreign Currency Translation". All transaction gains and losses from remeasurement of monetary balance sheet items denominated in non-dollar currencies are reflected in the statements of operations as financial income or expenses, as appropriate.

c. Principles of consolidation:

Intercompany transactions and balances have been eliminated in consolidation.

d. Cash equivalents:

The Company considers unrestricted highly liquid investments originally purchased with maturities of three months or less to be cash equivalents.

e. Short-term bank deposits:

Bank deposits with maturities of more than three months but less than one year are included in short-term bank deposits. Such short-term bank deposits are stated at cost.

f . Marketable securities:

The Company accounts for investments in debt securities in accordance with SFAS No. 115, "Accounting for Certain Investments in Debt and Equity Securities".

Management determines the appropriate classification of its investments in debt and equity securities at the time of purchase and reevaluates such determinations at each balance sheet date. Debt securities are classified as held-to-maturity when the Company has the positive intent and ability to hold the securities to maturity and are stated at amortized cost. The amortized cost of held-to-maturity securities is adjusted for amortization of premiums and accretion of discounts to maturity. Such amortization and decline in value judged to be other than temporary and interest are included in financial income, net. Debt securities for which the Company does not have the intent or ability to hold to maturity are classified as available-for-sale. Available-for-sale securities are carried at fair value, with the unrealized gains and losses, net of income taxes, reported as accumulated other comprehensive income (loss), a separate component of shareholders' equity.

Realized gains and losses are determined on a specific identification basis and included in the consolidated statements of operations.

g . Inventories:

Inventories are stated at the lower of cost or market value. The cost of raw materials and work-in-progress is determined by the "average cost" method and the cost of finished goods - on the basis of computed manufacturing costs.

The Company evaluates periodically the quantities on hand relative to current selling prices and historical and forecasted sales volume. Based on these evaluations, where appropriate, provisions are made in the period to write inventory down to its net realizable value.

h . Investments in affiliates:

Investments in non-marketable securities of an affiliate are recorded at the lower of cost or estimated fair value since the Company does not have the ability to exercise significant influence over operating and financial policy of the affiliate.

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 rates:

	%
Computers and peripheral equipment	20 - 33
Office furniture and equipment	6 - 20
Motor vehicles	15

Leasehold improvements are amortized by the straight-line method over the term of the lease or the estimated useful life of the improvements, whichever is shorter.

j. Other assets:

Other assets are stated at amortized cost. Amortization is calculated using the straight-line method over the estimated useful lives at the following annual rates:

	%
Goodwill	10
Core technology	25 - 33
Other intangible assets	20 - 33

The carrying values of goodwill, core technology and other intangible assets are periodically reviewed by management, based on the expected future undiscounted operating cash flows over the remaining goodwill amortization period. If this review indicates that goodwill, core technology and other intangible assets will not be recoverable, the carrying value of the goodwill, core technology and other intangible assets is reduced to estimated fair value. Based on its most recent analyses, management believes that no impairment of other assets exists as of December 31, 2000.

k. Revenue recognition:

The Company generates revenues from sales of products, which includes hardware and software solutions delivered together, software licensing, fixed price contracts, support services and maintenance.

The Company sells its products primarily indirectly through resellers, integrators and distributors, all of whom are considered end users and through its direct sales force. Sales to distributors that are deemed consignment sales are recognized as revenue only upon sale to a final customer.

In December 1999, the SEC issued Staff Accounting Bulletin No. 101 ("SAB 101"), as amended in June 2000, which summarizes the staff's views in applying generally accepted accounting principles to revenue recognition in financial statements. The Company adopted SAB 101 during the fourth quarter of 2000.

Revenues from product sales and software license agreements are recognized when all criteria outlined in Statement Of Position (SOP) 97-2 "Software Revenue Recognition" (as amended) are met. Revenue from products and license fees is recognized when persuasive evidence of an agreement exists, delivery of the product has occurred, the fee is fixed or determinable, no further obligations exist and collectibility is probable.

Where software 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 98-9 "Modification of SOP 97-2, Software Revenue Recognition With Respect to Certain Transactions". The Company's VSOE used to allocate the sales price to support services

and maintenance is based on the price charged when these elements are sold separately. 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 97-2, as amended, are satisfied. Under the residual method any discount in the arrangement is allocated to the delivered element.

The Company maintains a provision for product returns in accordance with SFAS No. 48 "Revenue Recognition When Right of Return Exists." The provision was deducted from revenues. The provision was estimated based on the Company's past experience.

The Company recognizes revenues from fixed price contracts that require significant customization, integration and installation based on SOP 81-1 "Accounting for Performance of Construction-Type and Certain Production - Type Contracts", using the percentage-of-completion method of accounting based on the value added and results achieved out of the completeness of the product as a whole. In order to verify the measure of the added value, the Company must identify elements or subcomponents of those elements. Provisions for estimated losses on uncompleted contracts are made in the period in which such losses are determined. As of December 31, 2000, no such estimated losses were identified.

Revenues from maintenance and support services are recognized ratably over the contractual period or as services are performed.

Deferred revenue includes amounts received from customers for which revenue has not been recognized.

l. Warranty costs:

Provisions for warranty are made at the time revenues are recognized for estimated warranty costs based on the Company's experience.

m. Research and development costs:

Research and development costs (net of grants and participations) incurred in the process of software production before establishment of technological feasibility are charged to expenses as incurred. Costs of the production of a product master incurred subsequent to the establishment of technological feasibility are capitalized according to the principles set forth in SFAS No. 86 "Accounting for the Costs of Computer Software to be Sold, Leased or Otherwise Marketed". Based on the Company's product development process, technological feasibility is established upon completion of a detailed program design or a working model.

Costs incurred by the Company between completion of the detailed program design or working model and the point at which the product is ready for general release have been capitalized.

Capitalized software development costs are amortized on a product-by-product basis commencing with general product release by the greater of the amount computed using the: (i) ratio that current gross revenues from sales

of the software bear to the total of current and anticipated future gross revenues from sales of that software, or (ii) the straight-line method over the estimated useful life of the software product (3 to 5 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. Based on its most recent analyses, management believes that no impairment of capitalized software development costs exists as of December 31, 2000.

n. Income taxes:

The Company accounts for income taxes in accordance with SFAS 109, "Accounting for Income Taxes". This statement prescribes the use of the liability method whereby deferred tax asset and liability account balances are determined based on differences between financial reporting and tax bases of assets and liabilities and are measured using the enacted tax rates and laws that will be in effect when the differences are expected to reverse. The Company provides a valuation allowance, if necessary, to reduce deferred tax assets to their estimated realizable value.

o. Government grants:

Grants from the Government of Israel for funding research and development are recognized at the time the Company is entitled to such grants on the basis of the related costs incurred and recorded as a reduction of research and development costs.

p. Concentrations of credit risk:

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

The Company's cash and cash equivalents and short-term bank deposits are invested in deposits in U.S. dollars with major international banks. Such deposits in the United States may be in excess of insured limits 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 Company's trade and unbilled receivables are derived from sales to customers located primarily in North America and Europe. The Company performs ongoing credit evaluations of its customers and, to date, has not experienced any material losses. An allowance for doubtful accounts is provided with respect to specific debts that the Company has determined to be doubtful of collection.

The Company's marketable securities include investment in debentures of U.S. corporations. Management believes that those corporations are financially sound, the portfolio is well diversified, and accordingly, minimal credit risk exists with respect to those marketable securities.

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

q. Severance pay:

NICE and its Israeli subsidiaries' liability for severance pay is calculated pursuant to Israeli 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 is fully provided by monthly deposits with insurance policies, deposits with severance pay funds and by an accrual.

The deposited funds include profits accumulated up to the balance sheet date. The deposited funds may be withdrawn only upon the fulfillment of the obligation pursuant to Israeli severance pay law or labor agreements. The value of the deposited funds is based on the cash surrender value of these policies and includes immaterial profits.

Severance pay expense for 1998, 1999 and 2000 was $1,242, $1,908 and $1,255, respectively.

r. Basic and diluted earnings (loss) per share:

Basic earnings (loss) per share are computed based on the weighted average number of ordinary shares outstanding during each year. Diluted earnings per share are computed based on the weighted average number of ordinary shares outstanding during each year plus dilutive potential equivalent ordinary shares considered outstanding during the year, in accordance with SFAS No. 128, "Earnings Per Share".

s. Stock-based compensation:

The Company has elected to follow Accounting Principles Board Opinion No. 25 ("APB 25"), "Accounting for Stock Issued to Employees" and Interpretation No. 44 "Accounting for Certain Transactions Involving Stock Compensation" ("FIN 44") in accounting for its employee stock option plan. Under APB 25, when the exercise price of the Company's options is less than the market value of the underlying shares on the date of grant, compensation expense is recognized. The pro forma information with respect to the fair value of the options is provided in accordance with the provisions of SFAS No. 123 "Accounting for Stock-based Compensation" (see Note 12b).

The Company applies SFAS No. 123 and EITF 96-18 "Accounting for Equity Instruments that are Issued to Other than Employees for Acquiring, or in Conjunction with Selling, Goods or Services" with respect to options issued to non-employees. SFAS No. 123 requires use of an option valuation model to measure the fair value of the options at the grant date.

t. Fair value of financial instruments:

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

The carrying amount reported in the balance sheet for cash and cash equivalents, short-term bank deposits, trade and unbilled receivables, short-term bank credit and trade payables approximates their fair value due to the short-term maturities of such instruments.

The fair value for marketable U.S. corporate securities is based on quoted market prices.

u. Advertising expenses:

Advertising expenses are charged to expenses as incurred.

v. Impact of recently issued accounting standards:

In June 1998, the Financial Accounting Standards Board issued SFAS No. 133, "Accounting For Derivative Instruments And Hedging Activities", as amended, which is required to be adopted in years beginning after June 15, 2000. Because of the Company's minimal use of derivatives, management does not anticipate that the adoption of the new Statement will have a significant effect on earnings or the financial position of the Company.

Note 3. MARKETABLE SECURITIES

	Amortized cost		Gross unrealized losses		Estimated fair value	
December 31	1999	2000	1999	2000	1999	2000
U.S. debentures	$ 47,954	$ 55,005	$ 251	$ 461	$ 47,703	$ 54,544

As of December 31, 1999 and 2000 all the Company's securities are classified as held-to-maturity. Prior to December 31, 1999, some of the Company's marketable securities were classified as available-for-sale.

Gross realized gains on sale of available-for-sale securities included in earnings in 1998 and 1999 totaled $ 14 and $ 15, respectively. Gross realized losses on sale of available-for-sale securities included in earnings in 1998 totaled $ 2. In 1998 and 1999 the unrealized gains and losses were immaterial. The Company did not realize any gains or losses on held-to-maturity securities in 1999 and 2000.

The proceeds from sales of available-for-sale securities in 1998 and 1999 totaled $ 384 and $ 269, respectively.

The scheduled maturities of held-to-maturity securities at December 31, 2000 are as follows:

	Amortized cost	Estimated fair value
Held-to-maturity:		
Due within one year	$ 29,089	$ 28,622
Due after one year through five years	25,916	25,922
	$ 55,005	$ 54,544

The fair market value of marketable U.S. corporate securities is $ 47,703 and $ 54,544 as of December 31, 1999 and 2000, respectively.

Note 4. OTHER RECEIVABLES AND PREPAID EXPENSES

December 31	1999	2000
Government authorities	$ 1,852	$ 2,434
Interest receivable	2,298	1,649
Due from SCI	–	5,140
Prepaid expenses	1,208	1,654
Other	1,152	1,117
	$ 6,510	$ 11,994

Note 5. INVENTORIES

December 31	1999	2000
Raw materials	$ 6,228	$ 10,712
Work in progress	904	1,170
Finished goods	3,642	9,277
	$ 10,774	$ 21,159

Note 6. INVESTMENT IN AFFILIATES

NICE's investment in Espro Engineering (1992) Ltd. is presented using the cost method of accounting in the amount of $ 229 as of December 31, 1999 and 2000 and represents 8.6% of Espro Engineering (1992) Ltd.'s equity.

In 2000, NICE invested in CustomerSat an amount of $ 1,200, which represents 6.3% of CustomerSat's equity. The investment is presented using the cost method of accounting.

Note 7. PROPERTY AND EQUIPMENT, NET

December 31	1999	2000
Cost:		
Computers and peripheral equipment	$ 15,778	$ 26,780
Office furniture and equipment	6,275	8,884
Motor vehicles	6,172	5,694
Leasehold improvements	3,031	3,883
	31,256	45,241
Accumulated depreciation:		
Computers and peripheral equipment	7,451	13,657
Office furniture and equipment	1,642	2,548
Motor vehicles	1,568	2,139
Leasehold improvements	603	1,001
	11,264	19,345
Depreciated cost	$ 19,992	$ 25,896

Depreciation expense totaled $ 3,382, $ 5,107 and $ 8,101 for the years ended December 31, 1998, 1999 and 2000, respectively.

As for pledges, see Note 10b.

U.S. dollars in thousands (except per share data)

Note 8. OTHER ASSETS, NET

December 31	1999	2000
Cost:		
Capitalized computer software costs	$ 5,913	$ 10,643
Goodwill	3,242	29,679
Technology	1,800	3,989
Other intangible assets	1,362	2,373
	12,317	46,684
Accumulated amortization:		
Capitalized computer software costs	1,487	3,108
Goodwill	309	979
Technology	1,128	2,066
Other intangible assets	355	750
	3,279	6,903
Amortized cost	$ 9,038	$ 39,781

Amortization expense amounted to $ 1,162, $ 1,691 and $ 3,624 for the years ended December 31, 1998, 1999 and 2000, respectively.

Note 9. ACCRUED EXPENSES AND OTHER LIABILITIES

December 31	1999	2000
Employees and payroll accruals	$ 4,749	$ 9,565
Accrued expenses	3,789	6,936
Deferred revenues	1,356	6,675
Other	616	291
	$ 10,510	$ 23,467

Note 10. COMMITMENTS AND CONTINGENT LIABILITIES

a. Lease commitments:

The Company leases various office space, office equipment and motor vehicles under operating leases.

1. The Company's facilities are rented under several operating leases.

   Future minimum lease commitments under non-cancelable operating leases for the years ended December 31, are as follows:

2001	$ 4,206
2002	4,099
2003	1,712
2004	325
2005 and thereafter	269
	$ 10,611

   Rent expense for the years ended December 31, 1998, 1999 and 2000 was approximately $ 2,869, $ 3,246 and $ 4,011, respectively.

2. The Company leases its motor vehicles under cancelable operating lease agreements for periods through 2003.

   The minimum payment under these operating leases, upon cancellation of these lease agreements, amounted to $ 264 as of December 31, 2000.

   Lease expenses for the years ended December 31, 1998, 1999 and 2000 were $ 0, $ 0 and $ 70, respectively.

b. Security interests and pledges:

The Company provided a guarantee: in the amount of $ 93 to the Chamber of Commerce and Industry to secure the return of equipment shipped abroad; in the amount of $ 3,978 in respect of liability for projects in progress and in the amount of $ 393 in the aggregate for the performance of projects to customers who made advance payments in respect of said projects. The Company provided a guarantee in the amount of $ 30 in respect of premises leased in France; of $28 in respect of warranty of its product and in the amount of $162 in respect of bids.

c. Legal proceedings

Lawsuits have been lodged against the Company in the ordinary course of business. The Company intends to defend itself vigorously against those lawsuits. Management can not predict the outcome of the lawsuits nor can they make any estimate of the amount of damages; therefore, no provision has been made for the lawsuits.

1. On February 8, 2001 the trading price of the Company's stock dropped following the Company's announcement that it would be restating its financial statements for the first three quarters of 2000 and for the year ended December 31, 1999 and that the Company was revising downward its revenue estimate for the final quarter of 2000. Thereafter, various plaintiffs filed against the Company and certain of its present or former officers and directors, fourteen class action suits in the United States District Court for the District of New Jersey and one in the District Court of Tel Aviv. While there are differences among the claims, the plaintiffs essentially contend that the Company and the individual defendants misrepresented to investors the financial results of the Company and the value of the Company's securities. Damages are sought in an unspecified amount. The U.S. plaintiffs have moved to consolidate the fourteen actions. Once a consolidated amended complaint is filed, the defendants will subsequently answer, move or otherwise respond. In Israel, a first court deliberation will be held in mid June, 2001.

2. On June 19, 2000, the Company was sued by Dictaphone Corp. in the District Court of Connecticut for patent infringement of two U.S. patents. Damages are sought in an unspecified amount. The Company filed counterclaims on August 21, 2000. The parties are actively engaged in discovery proceedings and NICE intends to vigorously contest the lawsuit.

Note 11. TAXES ON INCOME

a. Measurement of taxable income 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 measured in U.S. dollars. The difference between the annual change in the Israeli CPI and in the NIS/dollar exchange rate causes a further difference between taxable income and the income before taxes shown in the financial statements. In accordance with paragraph 9(f) of SFAS No. 109, the Company has not provided deferred income taxes on the difference between results using the functional currency and the tax basis of assets and liabilities.

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

Certain production facilities of NICE have been granted the status of "Approved Enterprise" under the Law, in three separate investment programs.

According to the provisions of the Law, NICE elected the "alternative benefits" and has waived government grants in return for a tax exemption.

Income derived from the first program will be tax-exempt for a period of four years, commencing 1999, and will be taxed at the reduced rate of 15%-25% (based on the percentage of foreign ownership in each taxable year) for an additional period of six years.

Income derived from the second program will be tax-exempt for a period of four years, commencing 1997, and will be subject to corporate taxes at the reduced rate of 15%-25% (based on the percentage of foreign ownership in each taxable year) for an additional period of six years.

Income derived from the third program will be tax-exempt for a period of two years, commencing with the year the Company first earns taxable income, and will be taxed at the reduced rate of 15%-25% (based on the percentage of foreign ownership in each taxable year) for an additional period of eight years.

The period of tax benefits, detailed above, is subject to limits of the earlier of 12 years from the commencement of production or 14 years from receiving the approval.

The entitlement to the above benefits is conditional upon NICE's fulfilling the conditions stipulated by the above Law, regulations published thereunder and the instruments of approval for the specific investments in an "Approved Enterprise". In the event of failure to comply with these conditions, the benefits may be canceled and the Company may be required to refund the amount of the benefits, in whole or in part, including interest.

The tax-exempt income attributable to the "Approved Enterprise" can be distributed to shareholders without subjecting NICE to taxes only upon the complete liquidation of the Company. As of December 31, 2000, retained earnings included approximately $ 17,517 in tax exempt profits earned by the Company's "Approved Enterprise". NICE has decided not to declare dividends out of such tax exempt income. Accordingly, no deferred income taxes have been provided on income attributable to NICE's "Approved Enterprises".

If the retained tax exempt income is distributed in a manner other than in the complete liquidation of NICE, it would be taxed at the corporate tax rate applicable to such profits as if NICE had not elected the alternative tax benefits (currently 20%) and an income tax liability would be incurred of approximately $ 3,503 as of December 31, 2000.

Income from sources other than the "Approved Enterprise", during the period of benefits, will be taxable at regular tax rates - currently 36%.

The Law also entitles NICE to claim accelerated depreciation on equipment used by the "Approved Enterprise" during five tax years.

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

NICE is an industrial company under the above law and as such is entitled to certain tax benefits, including accelerated depreciation, deduction of public offering expenses in three equal annual installments and amortization of patents and other intangible property rights as a deduction for tax purposes.

d. Net operating loss carryforwards:

As of December 31, 2000, the Company had $ 14,604 Israeli net operating loss carryforwards, which can be carried forward and offset against taxable income indefinitely.

As of December 31, 2000, the Company had a U.S. federal net operating loss carryforward of approximately $ 14,468, which can be carried forward and offset against taxable income for 20 years no later than 2009 to 2021.

e. Deferred income taxes:

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

December 31	1999	2000
Net operating loss carryforwards	$ 9,370	$ 5,787
Reserves and allowances	2,416	1,664
Net deferred tax asset before valuation allowance	11,786	7,451
Valuation allowance	(11,786)	(7,451)
Net deferred tax asset	$ –	$ –

The subsidiaries in the U.S. have provided valuation allowances in respect of deferred tax assets resulting from tax loss carryforwards, due to their history of operating losses. Management currently believes that it is more likely than not that the deferred tax asset in respect of the loss carryforwards and other temporary differences will not be utilized.

Notes To The Consolidated Financial Statements

U.S. dollars in thousands (except per share data)

f. 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 consolidated statements of operations is as follows:

Year ended December 31	1998	1999	2000
Income (loss) before income taxes, as reported in the consolidated statements of operations	$ 4,826	$ 10,901	$ (5,046)
Statutory tax rate in Israel	36%	36%	36%
Theoretical tax expense (income tax benefit)	$ 1,737	$ 3,924	$ (1,817)
Losses and other items for which a valuation allowance was provided	3,248	1,124	7,302
"Approved Enterprise" benefit (1)(2)	(4,536)	(2,394)	–
In-process research and development write-off and amortization of other intangible assets	1,888	1,818	2,517
Issuance expenses and tax benefits in respect of options to employees which were allowed as an expense and in respect of which deferred taxes were not provided	(1,371)	(2,856)	(5,736)
Interest income subject to lower tax rate	(1,401)	(1,898)	(2,135)
Non-deductible expenses and other	782	356	142
Actual tax expense	$ 347	$ 74	$ 273
(1) Basic per share effect of "Approved Enterprise" benefits	$ 0.41	$ 0.21	$ –
(2) Diluted per share effect of "Approved Enterprise" benefits	$ 0.38	$ 0.20	$ –

g. Income (loss) before income taxes is comprised as follows:

Year ended December 31	1998	1999	2000
Domestic	$ 12,536	$ 12,887	$ 2,740
Foreign	(7,710)	(1,986)	(7,786)
	$ 4,826	$ 10,901	$ (5,046)

h. The provision for income taxes is comprised as follows:

Year ended December 31	1998	1999	2000
Current taxes	$ 347	$ 84	$ 273
Previous years - deferred taxes	–	(10)	–
	$ 347	$ 74	$ 273
Domestic	$ 330	$ 80	$ 90
Foreign	17	(6)	183
	$ 347	$ 74	$ 273

Note 12. SHARE CAPITAL

a. The ordinary shares of the Company are traded on the Tel Aviv Stock Exchange and its American Depositary Shares ("ADSs") are traded on NASDAQ.

In April 1998, the Company issued 35,110 ADSs of NICE as part of the consideration for the acquired assets and liabilities of IBS (see Note 1b).

In April 2000, the Company issued securities of a wholly-owned subsidiary of NICE exchangeable for 150,000 ADSs to the shareholders of CPS as part of the consideration for the acquired shares of CPS (See Note 1d).

In December 2000, the Company issued ADSs of NICE as part of the consideration for the acquisition of certain assets and liabilities of SCI (See Note 1e).

b. Stock option plans:

In 1995, the Company adopted an employee stock option plan (the "1995 Option Plan"). Under the 1995 Option Plan, employees and officers of the Company may be granted options to acquire ordinary shares. The options to acquire ordinary shares, which may be determined by the board of directors of the Company, are granted at an exercise price, subject to certain exceptions, of not less than the fair market value of the ordinary shares on the grant date. 6,271,016 of the 1995 options were granted at an exercise price of not less than the fair market value of the ordinary shares at the date of grant.

The options generally vest over a four-year period from the date of grant. As of February 15, 2000, the board of directors of the Company adopted a resolution amending the exercise terms for any option to be granted

subsequent to February 15, 2000 under the 1995 Option Plan whereby 25% of the stock options granted become exercisable on the first anniversary of the date of grant and 6.25% become exercisable once every quarter during the subsequent three years. The options expire no later than 6 years from the date of grant.

In 1996, the Company adopted the 1997 Executive Share Option Plan (the "1997 Option Plan"). Under the terms of the 1997 Option Plan, stock options will be exercisable during a 60-day period ending four years after grant. Notwithstanding the foregoing, if the year-end earnings per share of the Company shall reach certain defined targets, 40% of such stock options shall become exercisable; if earnings per share shall reach certain higher defined targets, an additional 30% of such stock options shall become exercisable; and if earnings per share shall reach certain higher defined targets, an additional 30% of such stock options shall become exercisable, provided that with respect to all of the above-referenced periods, the operating profit of the Company shall not be less than 10% of revenues and earnings per share shall exclude any non-recurring expenses related to mergers and acquisitions. Notwithstanding the foregoing, none of the stock options shall be exercisable before the expiration of two years from the date of issuance. 950,000 of the 1997 options were granted at an exercise price of not less than the fair market value of the ordinary shares at the date of grant.

On December 9, 1998, the board of directors decided to reduce the exercise price of all employee stock options, excluding the options of the members of the board of directors, that were not exercised, or forfeited and have an original exercise price above $ 22.5. The amount of options repriced was 1,122,066, and their new exercise price was determined at $ 22.5, the fair market value of the ordinary share on this date. The original exercise price of these options ranged between $ 33-$ 42.

A summary of the Company's stock option activity and related information for the years ended December 31, 1998, 1999 and 2000 is as follows:

	1998		1999		2000	
	Number of options	Weighted average exercise price	Number of options	Weighted average exercise price	Number of options	Weighted average exercise price
Outstanding at the beginning of the year	2,140,516	$ 22.23	2,268,291	$ 22.66	3,036,591	$ 26.37
Granted	596,000	22.50	1,702,500	27.78	3,116,200	69.48
Exercised	(179,350)	11.34	(590,225)	18.02	(615,643)	21.79
Forfeited	(288,875)	26.21	(343,975)	23.23	(981,125)	51.83
Cancelled	–	–	–	–	(92,500)	70.88
Outstanding at the end of the year	2,268,291	$ 22.66	3,036,591	$ 26.37	4,463,523	$ 50.58
Exercisable at year end	216,825	$ 17.80	138,583	$ 20.24	307,744	$ 27.45

The options outstanding as of December 31, 2000 have been separated into exercise price categories as follows:

Exercise price	Options outstanding as of December 31, 2000	Weighted average remaining contractual life	Weighted average exercise price	Options exercisable as of December 31, 2000	Weighted average exercise price of options exercisable
		(Years)			
$ 7.80	4,250	1.03	$ 7.80	4,250	$ 7.80
$ 13.40 - $ 20.00	149,520	1.93	$ 17.59	37,520	$ 18.81
$ 21.38 - $ 30.30	1,352,303	3.77	$ 23.48	200,224	$ 23.48
$ 39.96 - $ 57.38	1,020,750	4.98	$ 49.64	65,750	$ 46.00
$ 64.13 - $ 78.88	1,936,700	5.25	$ 72.63	–	$ –
	4,463,523		$ 50.58	307,744	$ 27.45

When the Company has recorded deferred stock compensation for options issued with an exercise price below the fair value of the ordinary shares, the deferred compensation is amortized and recorded as compensation expense ratably over the vesting period of the options.

Compensation expense of approximately $ 293, $ 207 and $ 128 were recognized during the years ended December 31, 1998, 1999 and 2000, respectively.

Pro forma information regarding net income (loss) and earnings (loss) per share is required (for grants issued after December 1994) by SFAS No. 123, and has been determined as if the Company had accounted for its employee options under the fair value method prescribed by that statement. The fair value for these options was estimated at the date of grant using a Black-Scholes option pricing model with the following weighted average assumptions for 1998, 1999 and 2000: risk-free interest rates of 5.5%, 6%, and 6%, respectively; dividend yields of 0%, 0% and 0%, respectively; volatility factors of the expected market price of the Company's ordinary shares of 0.752, 0.738 and 0.821, respectively, and a weighted average expected life of the option of 3, 3 and 3.5 years, respectively.

The Black-Scholes option pricing model was developed for use in estimating the fair value of traded options that have no vesting restrictions and are fully transferable. In addition, option valuation models require the input of highly subjective assumptions, including the expected stock price volatility. Because the Company's employee stock options have characteristics significantly different from those traded options and because changes in the subjective input assumptions can materially affect the fair value estimate, in management's opinion, the existing models do not necessarily provide a reliable single measure of the fair value of its employee stock options.

Weighted average fair values and weighted average exercise prices of options whose exercise price is equal or less than the market price of the shares at date of grant are as follows:

	Weighted Average Fair Value of Options Granted at an Exercise Price			Weighted Average Exercise Price of Options Granted at an Exercise Price		
Year ended December 31	1998	1999	2000	1998	1999	2000
Less than fair value at date of grant	$ –	$ –	$ 55.11	$ –	$ –	$ 22.707
Equal to fair value at date of grant	$ 18.17	$ 12.44	$ 38.93	$ 22.50	$ 27.50	$ 69.042

Pro forma information under SFAS No. 123:

Year ended December 31	1998	1999	2000
Net income (loss) as reported	$ 4,479	$ 10,827	$ (5,319)
Pro forma net income (loss)	$ (3,453)	$ 1,706	$ (49,163)
Pro forma basic earnings (loss) per share	$ (0.31)	$ 0.15	$ (3.97)
Pro forma diluted earnings (loss) per share	$ (0.31)	$ 0.14	$ (3.97)

c. Employee Stock Purchase Plan:

In February 1999, the Company's board of directors adopted the Employee Stock Purchase Plan (the "Purchase Plan"). Eligible employees can have up to 10% of their earnings withheld, up to certain maximums, to be used to purchase ordinary shares. The price of ordinary shares purchased under the Purchase Plan will be equal to 85% of the lower of the fair market value of the ordinary share on the commencement date of each offering period or on the semi-annual purchase date.

d. Warrants:

In December 1999, the Company granted a warrant to purchase 50,000 ordinary shares in consideration of the acquisition of STS. The warrant is exercisable through December 2001 at a price of $ 40 per share. Fair market value was estimated using the Black-Scholes valuation model with the following weighted average assumptions:

expected volatility of 0.738, risk-free interest rate of 6%, dividend yield of 0% and weighted average expected life of 2 years. The Company accounted for this transaction in accordance with EITF 96-18 and SFAS No. 123 and recorded $ 229 as part of the total consideration for the acquisition of STS. During 2000, STS exercised 18,750 warrants in the amount of $ 750.

e. Dividends:

In the event that cash dividends are declared in the future, such dividends will be paid in NIS. The Company does not intend to pay cash dividends in the foreseeable future.

Note 13. GEOGRAPHIC OPERATING INFORMATION

a. Summary information about geographic areas:

The Company manages its business on a basis of one reportable segment. See note 1a for a brief description of the Company's business. The following data is presented in accordance with SFAS No. 131 "Disclosure About Segments of an Enterprise and Related Information". Total revenues are attributed to geographic areas based on location of end customers.

The following presents total revenues and long-lived assets for the years ended December 31, 1998, 1999 and 2000:

	1998		1999		2000	
	Total revenues	Long-lived assets	Total revenues	Long-lived assets	Total revenues	Long-lived assets
Israel	$ 2,023	$ 16,484	$ 1,678	$ 24,271	$ 4,490	$ 59,880
North America	38,360	4,372	58,499	4,874	81,646	7,129
Europe (except United Kingdom)	22,922	154	28,376	95	27,447	59
United Kingdom	11,352	27	10,467	19	8,430	38
Other	16,313	–	18,391	–	31,150	–
	$ 90,970	$ 21,037	$ 117,411	$ 29,259	$ 153,163	$ 67,106

b. Product lines:

Total revenues from external customers divided on the basis of the Company's product lines are as follows:

Year ended December 31	1998	1999	2000
Revenues:			
CEM	$ 85,778	$103,066	$128,655
Digital video	–	5,670	15,824
COMINT	5,192	8,675	8,684
	$ 90,970	$117,411	$153,163

c. Major customer data as a percentage of total revenues:

Year ended December 31	1998	1999	2000
Customer A	7.0 %	16.4 %	18.6 %
Customer B	10.0	6.0	3.1
	17.0 %	22.4 %	21.7 %

Notes To The Consolidated Financial Statements

U.S. dollars in thousands (except per share data)

Note 14. SELECTED STATEMENTS OF OPERATIONS DATA

a. Research and development, net:

Year ended December 31	1998	1999	2000
Total costs	$ 12,681	$ 16,712	$ 27,402
Less: grants and participations	–	(317)	(1,174)
Less: capitalization of software development costs	(1,930)	(2,570)	(4,730)
	$ 10,751	$ 13,825	$ 21,498

b. Financial income, net:

	1998	1999	2000
Financial expenses:			
Interest	$ (49)	$ (40)	$ (80)
Other expenses	(79)	(223)	(328)
Foreign currency translation	–	(555)	(163)
	(128)	(818)	(571)
Financial income:			
Gains, interest and amortization of premium/discount	1,003	2,307	3,326
Foreign currency translation	673	–	–
Interest	4,244	3,320	3,433
	5,920	5,627	6,759
	$ 5,792	$ 4,809	$ 6,188

c. Other special charges:

	1998	1999	2000
In-process research and development write-off (Note 1b,c,d)	$ 6,263	$ 5,155	$ 6,786
Reorganization expenses (Note 1b)	500	–	–
Relocation expenses	2,260	–	–
	$ 9,023	$ 5,155	$ 6,786

d. Advertising expenses

	1998	1999	2000
Advertising expenses	$ 2,074	$ 1,247	$ 1,485

e. Earnings (loss) per share:

The following table sets forth the computation of basic and diluted earnings (loss) per share:

1. Numerator:

Year ended December 31	1998	1999	2000
Net income (loss)	$ 4,479	$ 10,827	$ (5,319)
Numerator for basic and diluted earnings (loss) per share - income (loss) available to ordinary shareholders	$ 4,479	$ 10,827	$ (5,319)

2. Denominator:

Year ended December 31	1998	1999	2000
Weighted average number of shares	11,192	11,559	12,317
Denominator for basic earnings (loss) per share	11,192	11,559	12,317
Effect of dilutive securities:			
Employee stock options and warrants granted to non-employees	818	690	(*) –
Dilutive potential ordinary shares	818	690	(*) –
Denominator for diluted earnings (loss) per share - adjusted weighted average shares assuming exercise of options	12,010	12,249	12,317

(*) Antidilutive.

As of December 31, 1998, 1999 and 2000 options to purchase 0, 263 and 3,541 shares, respectively, were not included in the computation of diluted EPS because the effect would have been antidilutive.

Corporate Directory

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Dan Goldstein, Director
Ron Gutler, Director
Avshalom Horan, Director
David Kostman, Director
Benjamin Levin, Director
Eliezer Yones, Director
Haim Shani, President & Chief Executive Officer
Lauri Hanover, Corporate Vice President & Chief Financial Officer
Hagai Katz, Executive Vice President
Daphna Kedmi, Corporate Vice President, General Counsel & Corporate Secretary
Yoav Zaltzman, Corporate Vice President, Business Operations
Dr. Shlomo Shamir, President & CEO of NICE Systems, Inc.
Moti Dor-On, Corporate Vice President & General Manager ISS Division
Avishai Elazar, Corporate Vice President & General Manager VIM Division
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Form F-20

Copies of the Company's Annual Report on Form F-20, as filed with the Securities and Exchange Commission, may be obtained by shareholders without charge by written request.

American Depositary Shares (ADSs)

The Company's ADSs are traded over the counter (National Market System) with the NASDAQ symbol NICE. The Company's Ordinary Shares are traded on the Tel Aviv Stock Exchange.

Design & Production: Portnov-Mishan
Text: Rena Kronenthal
Printed in Israel

Part no. 406F0023-05

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