

DSP GROUP INC /DE/  
Form 10-Q  
May 08, 2007  
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## SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

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### FORM 10-Q

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(Mark One)

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

For the Quarterly Period Ended March 31, 2007

or

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

For the transition period from \_\_\_\_\_ to \_\_\_\_\_

Commission File Number 0-23006

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## DSP GROUP, INC.

(Exact name of registrant as specified in its charter)

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Delaware  
(State or other jurisdiction of  
incorporation or organization)

94-2683643  
(I.R.S. employer  
identification number)

3120 Scott Boulevard, Santa Clara, California  
(Address of Principal Executive Offices)

95054  
(Zip Code)

Registrant's telephone number, including area code: (408) 986-4300

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Indicate by check mark whether the registrant: (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes  No

Indicate by check mark whether the registrant is an accelerated filer (as defined in Rule 12b-2 of the Exchange Act). Yes  No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of accelerated filer and large accelerated filer in Rule 12b-2 of the Exchange Act. Large accelerated filer  Accelerated filer  Non-accelerated filer

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes  No

As of May 1, 2007, there were 28,494,060 shares of Common Stock (\$.001 par value per share) outstanding.

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**Table of Contents****PART I. FINANCIAL INFORMATION****ITEM 1. FINANCIAL STATEMENTS****DSP GROUP, INC.****CONDENSED CONSOLIDATED BALANCE SHEETS**

(US dollars in thousands, except share and per share data)

	<b>March 31, 2007 Unaudited</b>	<b>December 31, 2006 Audited</b>
<b>ASSETS</b>		
<b>CURRENT ASSETS:</b>		
Cash and cash equivalents	\$ 35,168	\$ 37,344
Short-term investments	30,687	22,698
Marketable securities	103,372	109,472
Trade receivables, net	26,069	21,489
Deferred income taxes	1,503	1,516
Other accounts receivable and prepaid expenses	5,199	4,049
Inventories	12,648	14,366
<b>TOTAL CURRENT ASSETS</b>	<b>214,646</b>	<b>210,934</b>
<b>PROPERTY AND EQUIPMENT, NET</b>	<b>13,779</b>	<b>12,644</b>
<b>LONG-TERM ASSETS:</b>		
Marketable securities	186,066	179,368
Long-term prepaid expenses and lease deposits	689	672
Deferred income taxes	2,562	1,987
Severance pay fund	5,905	5,689
Intangible assets, net	908	1,194
Goodwill	1,500	1,500
	<b>197,630</b>	<b>190,410</b>
<b>TOTAL ASSETS</b>	<b>\$ 426,055</b>	<b>\$ 413,988</b>

Note: The balance sheet at December 31, 2006 has been derived from the audited financial statements at that date.

See notes to condensed consolidated financial statements.

**Table of Contents****DSP GROUP, INC.****CONDENSED CONSOLIDATED BALANCE SHEETS**

(US dollars in thousands, except share and per share data)

	March 31, 2007 Unaudited	December 31, 2006 Audited
<b>LIABILITIES AND STOCKHOLDERS EQUITY</b>		
<b>CURRENT LIABILITIES:</b>		
Trade payables	\$ 20,177	\$ 12,205
Accrued compensation and benefits	6,429	9,215
Income taxes payables	12,238	10,359
Accrued expenses and other accounts payable	8,714	9,395
<b>TOTAL CURRENT LIABILITIES</b>	<b>47,558</b>	<b>41,174</b>
ACCRUED SEVERANCE PAY	6,246	6,065
<b>STOCKHOLDERS EQUITY:</b>		
Preferred stock, \$0.001 par value - Authorized shares: 5,000,000 at March 31, 2007 and December 31, 2006; Issued and outstanding shares: none at March 31, 2007 and December 31, 2006		
Common stock, \$0.001 par value - Authorized shares: 50,000,000 at March 31, 2007 and December 31, 2006; Issued and outstanding: 28,471,168 and 28,377,838 shares at March 31, 2007 and December 31, 2006, respectively	28	28
Additional paid-in capital	220,194	216,041
Treasury stock	(42,372)	(44,546)
Accumulated other comprehensive income	22	28
Retained earnings	194,379	195,198
<b>TOTAL STOCKHOLDERS EQUITY</b>	<b>372,251</b>	<b>366,749</b>
<b>TOTAL LIABILITIES AND STOCKHOLDERS EQUITY</b>	<b>\$ 426,055</b>	<b>\$ 413,988</b>

Note: The balance sheet at December 31, 2006 has been derived from the audited financial statements at that date.

See notes to condensed consolidated financial statements.

**Table of Contents****DSP GROUP, INC.****CONDENSED CONSOLIDATED STATEMENTS OF INCOME (UNAUDITED)**

(US dollars in thousands, except per share amounts)

	<b>Three months ended March 31,</b>	
	<b>2007</b>	<b>2006</b>
Revenues	\$ 49,288	\$ 51,952
Costs of revenues (1)	30,001	30,355
Gross profit	19,287	21,597
Operating expenses:		
Research and development (2)	12,757	10,901
Sales and marketing (3)	4,197	3,806
General and administrative (4)	3,596	2,800
Total operating expenses	20,550	17,507
Operating income	(1,263)	4,090
Interest and other income, net	3,652	3,109
Income before taxes on income	2,389	7,199
Taxes on income (5)	1,025	1,561
Net income	\$ 1,364	\$ 5,638
Net earnings per share:		
Basic	\$ 0.05	\$ 0.19
Diluted	\$ 0.05	\$ 0.18

- (1) Includes equity-based compensation expense in the amount of \$166 and \$78 for the three months ended March 31, 2007 and 2006, respectively.
- (2) Includes equity-based compensation expense in the amount of \$2,088 and \$1,222 for the three months ended March 31, 2007 and 2006, respectively.
- (3) Includes equity-based compensation expense in the amount of \$440 and \$268 for the three months ended March 31, 2007 and 2006, respectively.
- (4) Includes equity-based compensation expense in the amount of \$1,460 and \$925 for the three months ended March 31, 2007 and 2006, respectively.
- (5) Includes tax benefit resulting from equity-based compensation expense in the amount of \$185 and \$87 for the three months ended March 31, 2007 and 2006, respectively.

See notes to condensed consolidated financial statements.

**Table of Contents****DSP GROUP, INC.****CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS (UNAUDITED)**

(US dollars in thousands)

	<b>Three Months Ended March 31,</b>	
	<b>2007</b>	<b>2006</b>
<b>Net cash provided by operating activities</b>	\$ 7,122	\$ 4,066
<b>Investing activities</b>		
Purchase of marketable securities and short-term investments	(49,287)	(23,406)
Proceeds from maturity of marketable securities and short-term investments	40,300	10,500
Purchases of property and equipment	(1,212)	(795)
<b>Net cash used in investing activities</b>	(10,199)	(13,701)
<b>Financial activities</b>		
Issuance of Common Stock and Treasury Stock for cash upon exercise of options	901	26,618
<b>Net cash provided by financing activities</b>	901	26,618
<b>Increase (decrease) in cash and cash equivalents</b>	\$ (2,176)	\$ 16,983
<b>Cash and cash equivalents at the beginning of the period</b>	\$ 37,344	\$ 50,460
<b>Cash and cash equivalents at the end of the period</b>	\$ 35,168	\$ 67,443

See notes to condensed consolidated financial statements.

**Table of Contents****DSP GROUP, INC.****CONDENSED CONSOLIDATED STATEMENTS OF STOCKHOLDERS EQUITY****(UNAUDITED)****(US dollars in thousands)**

	Number of		Additional		Retained	Other	Total	Total
	Common	Common	Paid-In	Treasury	Earnings	Comprehensive	Comprehensive	Stockholders
	Stock	Stock	Capital	Stock		Income	Income	Equity
						(Loss)		
<b>Three Months Ended</b>								
<b>March 31, 2006</b>								
Balance at December 31, 2005	28,596	\$ 29	\$ 188,539	\$ (19,447)	\$ 179,968	\$ 45		\$ 349,134
Net income					5,638		\$ 5,638	5,638
Unrealized gain from hedging activities, net						(54)	(54)	(54)
<b>Total comprehensive income</b>							\$ 5,584	
Issuance of Treasury Stock upon purchase of Common Stock under employee stock purchase plan	40	(*)		926	(172)			754
Issuance of Treasury Stock upon exercise of stock options by employees	802	(*)	203	18,521	(4,416)			14,308
Insurance at Common Stock upon exercise at stock option by employees	803	1	13,886					13,887
Equity-based compensation			2,494					2,494
Balance at March 31, 2006	30,241	\$ 30	\$ 205,122	\$	\$ 181,018	\$ (9)		\$ 386,161
<b>Three Months Ended</b>								
<b>March 31, 2007</b>								
Balance at December 31, 2006	28,378	\$ 28	\$ 216,041	\$ (44,546)	\$ 195,198	\$ 28		\$ 366,749
Net income					1,364		\$ 1,364	1,364
Unrealized gain from hedging activities, net						(6)	(6)	(6)
<b>Total comprehensive income</b>							\$ 1,358	
Issuance of Treasury Stock upon purchase of Common Stock under employee stock purchase plan	44	(*)		1,029	(214)			815
Issuance of Treasury Stock upon exercise of stock options by employees	49	(*)		1,145	(484)			661
Equity based compensation			4,153					4,153
					(1,485)			(1,485)



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Cumulative impact of change in accounting for uncertainties in income taxes (FIN 48 - See note E)

Balance at March 31, 2007	28,471	\$ 28	\$ 220,194	\$ (42,372)	\$ 194,379	\$ 22	\$ 372,251
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(\*) Represents an amount lower than \$1.

See notes to condensed consolidated financial statements.

**Table of Contents****DSP GROUP, INC.****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS****March 31, 2007****(UNAUDITED)****(U.S. dollars in thousands, except share and per share data)****NOTE A BASIS OF PRESENTATION AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES**

The accompanying unaudited condensed consolidated financial statements have been prepared in accordance with generally accepted accounting principles in the United States for interim financial information and with the instructions to Form 10-Q and Article 10 of Regulation S-X. Accordingly, they do not include all of the information and footnotes required by generally accepted accounting principles for complete financial statements. In the opinion of management, all adjustments (consisting only of normal recurring accruals) considered necessary for a fair presentation have been included. Operating results for the three months ended March 31, 2007 are not necessarily indicative of the results that may be expected for the year ending December 31, 2007. For further information, reference is made to the consolidated financial statements and footnotes thereto included in the Annual Report on Form 10-K of DSP Group, Inc. (the Company) for the year ended December 31, 2006.

**FIN 48 - Uncertainty in income taxes:**

In June 2006, the Financial Accounting Standards Board ( FASB ) issued FASB interpretation ( FIN ) No. 48, Accounting for Uncertainty in Income Taxes – an Interpretation of FASB Statement 109 (FIN 48 ). FIN 48 establishes a single model to address accounting for uncertain tax positions. FIN 48 clarified the accounting for income taxes by prescribing the minimum recognition threshold a tax position is required to meet before being recognized in the financial statements. FIN 48 also provides guidance on derecognition, measurement, classification, interest and penalties, accounting in interim periods, disclosure and transition.

**NOTE B INVENTORIES**

Inventories are stated at the lower of cost or market value. Cost is determined using the average cost method. The Company periodically evaluates the quantities on hand relative to current and historical selling prices and historical and projected sales volume. Based on these evaluations, provisions are made in each period to write inventory down to its net realizable value. Inventories are composed of the following:

	<b>March 31, 2007 (Unaudited)</b>	<b>December 31, 2006 (Audited)</b>
Work-in-process	\$ 6,271	\$ 5,248
Finished goods	6,377	9,118
	<b>\$ 12,648</b>	<b>\$ 14,366</b>

**NOTE C NET EARNINGS PER SHARE**

Basic net earnings per share are computed based on the weighted average number of shares of Common Stock outstanding during the period. For the same periods, diluted net earnings per share further include the effect of dilutive stock options and stock appreciation rights outstanding during the period, all in accordance with SFAS No. 128, Earnings per Share. The following table sets forth the computation of basic and diluted net earnings per share:

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	<b>Three months ended March 31,</b>	
	<b>2007</b>	<b>2006</b>
Net income	\$ 1,364	\$ 5,638
Earnings per share:		
Basic	\$ 0.05	\$ 0.19
Diluted	\$ 0.05	\$ 0.18
Weighted average number of shares of Common Stock outstanding during the period used to compute basic net earnings per share (in thousands)	28,455	29,477
Incremental shares attributable to exercise of outstanding options (assuming proceeds would be used to purchase Treasury Stock) (in thousands)	236	1,307
Weighted average number of shares of Common Stock used to compute diluted net earnings per share (in thousands)	28,691	30,784

**NOTE D INVESTMENTS IN MARKETABLE SECURITIES**

The following is a summary of held-to-maturity securities at March 31, 2007 and December 31, 2006:

	<b>Amortized cost</b>		<b>Unrealized losses, net</b>		<b>Estimated fair value</b>	
	<b>March 31, 2007</b>	<b>December 31, 2006</b>	<b>March 31, 2007</b>	<b>December 31, 2006</b>	<b>March 31, 2007</b>	<b>December 31, 2006</b>
	<b>(Unaudited)</b>	<b>(Audited)</b>	<b>(Unaudited)</b>	<b>(Audited)</b>	<b>(Unaudited)</b>	<b>(Audited)</b>
US government obligations and political subdivisions	\$ 165,874	\$ 180,684	\$ (1,619)	\$ (2,225)	\$ 164,255	\$ 178,459
Corporate obligations	123,564	108,156	(412)	(775)	123,152	107,381
	\$ 289,438	\$ 288,840	\$ (2,031)	\$ (3,000)	\$ 287,407	\$ 285,840

The amortized cost of held-to-maturity debt securities at March 31, 2007, by contractual maturities, is shown below:

	<b>Amortized cost</b>	<b>Unrealized gains (losses)</b>		<b>Estimated fair value</b>
		<b>Gains</b>	<b>(Losses)</b>	
Due in one year or less	\$ 103,372	\$	\$ (610)	\$ 102,762
Due after one year to five years	186,066	143	(1,564)	184,645
	\$ 289,438	\$ 143	\$ (2,174)	\$ 287,407

The actual maturity dates may differ from the contractual maturities because debtors may have the right to call or prepay obligations without penalties.

The unrealized losses in the Company's investments in held-to-maturity marketable securities were caused by interest rate increases. The contractual cash flows of these investments are either guaranteed by the U.S. government or an agency of the U.S. government or were issued by highly rated corporations. Accordingly, it is expected that the securities would not be settled at a price less than the amortized cost of the Company's investment. Based on the immaterial severity of the impairments and the ability and intent of the Company to hold these investments until maturity, the held-to-maturity marketable securities were not considered to be other than temporarily impaired at March 31, 2007.



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**NOTE E INCOME TAXES**

The effective tax rate used in computing the provision for income taxes is based on projected fiscal year income before taxes, including estimated income by tax jurisdiction. The difference between the effective tax rate and the statutory rate is due primarily to foreign tax holiday and tax-exempt income in Israel. Tax provision for the three months ended March 31, 2007 and March 31, 2006 included the tax benefit associated with equity-based compensation expenses in the amount of \$185 and \$87, respectively. Tax provision as a percentage of pre-tax income was 43% for the three months ended March 31, 2007. Tax provision as a percentage of pre-tax income was 22% for the three months ended March 31, 2006.

In June 2006, FASB issued FIN 48 which establishes a single model to address accounting for uncertain tax positions. FIN 48 clarified the accounting for income taxes by prescribing the minimum recognition threshold a tax position is required to meet before being recognized in the financial statements. FIN 48 also provides guidance on derecognition, measurement, classification, interest and penalties, accounting in interim periods, disclosure and transition.

The Company adopted the provisions of FIN 48 effective January 1, 2007. As a result of the implementation of FIN 48, the Company recorded an increase of \$1,485 (including interest in the amount of \$240) associated with the liability for unrecognized tax benefits, which was accounted for as a reduction to the retained earnings balance as of January 1, 2007. As of January 1, 2007, the gross amount of unrecognized tax benefits was \$11,466.

The Company recognizes accrued interest related to unrecognized tax benefits in income tax expense. The Company had \$1,228 in interest related to unrecognized tax benefits accrued as of January 1, 2007. The Company and certain of its subsidiaries file income tax returns in the U.S. federal jurisdiction and various state and foreign jurisdictions. Currently the Company's U.S. federal income tax returns for 2003 and 2004 are under examination. The last examination conducted by U.S. tax authorities prior to the current examination was in respect to the Company's U.S. federal income tax returns for 1998.

With respect to DSP Group Ltd., the Company's Israeli subsidiary, the Company is no longer subject to income tax audits for years before 2004.

**NOTE F SIGNIFICANT CUSTOMERS**

The Company sells its products to customers primarily through a network of distributors and representatives. Revenues derived from sales through one distributor, Tomen Electronics Corporation ( Tomen Electronics ), accounted for 49% and 68% of the Company's total revenues for the three months ended March 31, 2007 and 2006, respectively. The Japanese market and the original equipment manufacturers (OEMs) that operate in that market are among the largest suppliers in the world with significant market share in the U.S. market for residential wireless products. Tomen Electronics sells the Company's products to a limited number of customers. One customer, Panasonic Communications Co., Ltd. ( Panasonic ), has continually accounted for a majority of the sales of Tomen Electronics. The loss of Tomen Electronics as a distributor and the Company's inability to obtain a satisfactory replacement in a timely manner would harm its sales and results of operations. Additionally, the loss of Panasonic or Tomen Electronics' inability to thereafter effectively market the Company's products would also harm the Company's sales and results of operations.

**NOTE G DERIVATIVE INSTRUMENTS**

Statement of Financial Accounting Standard No. 133, Accounting for Derivative Instruments and Hedging Activities ( SFAS No. 133 ), requires companies to recognize all of its derivative instruments as either assets or liabilities in the statement of financial position at fair value.

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For derivative instruments that are designated and qualify as a cash flow hedge (i.e., hedging the exposure to variability in expected future cash flows that is attributable to a particular risk), the effective portion of the gain or loss on the derivative instrument is reported as a component of other comprehensive income and reclassified into earnings in the same period or periods during which the hedged transaction affects earnings. Any gain or loss on a derivative instrument in excess of the cumulative change in the present value of future cash flows of the hedged item is recognized in current earnings during the period of change.

To protect against the increase in value of forecasted foreign currency cash flow resulting from salary and rent payments in New Israeli Shekels (NIS) during the year, the Company has instituted a foreign currency cash flow hedging program. The Company hedges portions of the anticipated payroll and lease payments of its Israeli facilities denominated in NIS for a period of one to twelve months with put options and forward contracts.

These forward contracts and put options are designated as cash flow hedges, as defined by SFAS No. 133, and are all effective as hedges of these expenses.

As of March 31, 2007 and December 31, 2006, the Company recorded comprehensive income of \$22 and \$28, respectively, from its put options and forward contracts in respect to anticipated payroll and rent payments expected in 2007. Such amounts will be recorded into earnings in the second quarter of 2007.

**NOTE J CONTINGENCIES**

From time to time, the Company may become involved in litigation relating to claims arising from its ordinary course of business. Also, as is typical in the semiconductor industry, the Company has been and may from time to time be notified of claims that the Company may be infringing patents or intellectual property rights owned by third parties. For example, in a lawsuit against Microsoft Corporation, AT&T asserted that the Company's TrueSpeech 8.5 algorithm includes certain elements covered by a patent held by AT&T. AT&T sued Microsoft, one of the Company's TrueSpeech 8.5 licensees, for infringement. The Company was not named in AT&T's suit against Microsoft. During 2002, the Company created a provision, which was included in the cost of product revenues, in respect of this legal exposure. The Company currently believes that there are no claims or actions pending or threatened against it, the ultimate disposition of which would have a material adverse effect on Company.

**NOTE K ACCOUNTING FOR EQUITY-BASED COMPENSATION**

Effective January 1, 2006, the Company adopted the fair value recognition provisions of SFAS 123(R). SFAS 123(R) establishes accounting for equity-based awards exchanged for employee services. Accordingly, equity-based compensation cost is measured at grant date, based on the fair value of the award, and is recognized as an expense over the employee's requisite service period. The Company previously applied APB 25 and related Interpretations and provided the required pro forma disclosures required under SFAS 123. The Company elected to adopt the modified prospective application method as provided by SFAS 123(R), and, accordingly, the Company recorded compensation costs as the requisite service rendered for the unvested portion of previously issued awards that remain outstanding at the initial date of adoption and any awards issued, modified, repurchased or cancelled after the effective date of SFAS 123(R). Upon adoption of SFAS 123(R), the Company also changed its method of valuation for equity-based awards granted beginning in fiscal year 2006 to an exercise multiple-based lattice option-pricing model (EMLM/binomial model) from the Black-Scholes option-pricing model (Black-Scholes model) which was previously used to present the Company's pro forma information required under SFAS 123. For options granted prior to 2006, the Company did not change its valuation method. Binomial models have evolved such that the currently available models are more capable of incorporating the features of the Company's employee stock options than closed-form models such as the Black-Scholes model.

**Table of Contents****Grants for Three months Ended March 31, 2007 and March 31, 2006:**

The weighted average estimated fair value of employee stock options and share appreciation rights ( SAR ) granted during the three months ended March 31, 2007 and March 31, 2006 was \$7.67 and \$10.29, per share, respectively, using the binomial model with the following weighted average assumptions (annualized percentages):

	Three months ended March 31, 2007	Three months ended March 31, 2006
Volatility	37.70%	42.25%
Risk-free interest rate	4.88%	4.5%
Dividend yield	0%	0%
Pre-vest cancellation rate	2.69%	1.76%
Post-vest cancellation rate	0.46%	2.36%
Suboptimal exercise factor	1.69	2.67

The expected life of employee stock options is impacted by all of the underlying assumptions used in the Company's model. The binomial model assumes that employees' exercise behavior is a function of the option's remaining contractual life and the extent to which the option is in-the-money (*i.e.*, the average stock price during the period is above the strike price of the stock option). The binomial model estimates the probability of exercise as a function of these two variables based on the history of exercises and cancellations of past option grants made by the Company. The expected life for options granted during the three months ended March 31, 2007 and 2006 derived from the binomial model was 5.47 and 4.97 years, respectively.

Pre-vesting forfeitures were estimated to be approximately 2.69% and 1.76% for the three months ended March 31, 2007 and 2006, respectively, based on historical experience. Post-vesting forfeitures rate was 0.46% and 2.36% for the three months ended March 31, 2007 and 2006, respectively, and is included in the valuation above.

**Employee Stock Benefit Plans**

As of March 31, 2007, the Company had five stock option plans and one employee stock purchase plan. As of March 31, 2007, approximately 242,000 shares of Common Stock remain available for grant under the Company's employees stock purchase plan and approximately 1,416,000 shares of Common Stock remain available for grant under the Company's stock option plans.

The table below presents a summary of information relating to the Company's stock option and SAR grants pursuant to its stock option plans:

	Number of Shares/SAR Units	Weighted Average Exercise Price	Weighted Average Remaining Contractual Term (years)	Aggregate Intrinsic Value (*) (in thousands)
Outstanding at January 1, 2007	6,465,381	\$ 24.61		
Options granted	180,950	\$ 21.69		
SAR units granted (**)	1,340,150	\$ 21.68		
Options / SAR units cancelled/forfeited/expired	219,722	\$ 27.50		
Options exercised	49,146	\$ 13.45		
Outstanding at March 31, 2007(***)	7,717,613	\$ 24.02	4.69	\$ 3,294
Exercisable at March 31, 2007(****)	3,651,769	\$ 23.61	3.00	\$ 3,271

(\*) Calculation of aggregate intrinsic value is based on the share price of the Company's Common Stock as of March 31, 2007 (\$19.0 per share).





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- (\*\*) Each SAR grant is convertible for a maximum number of shares of the Company's Common Stock equal to 50% of the SAR units subject to the grant.
- (\*\*\*) Due to the ceiling imposed on the SAR grants, the outstanding amount can be exercised for a maximum of 6,349,588 shares of the Company's Common Stock.
- (\*\*\*\*) Due to the ceiling imposed on the SAR grants, the currently exercisable amount can be exercised for a maximum of 3,629,269 shares of the Company's Common Stock.

Additional information about stock options outstanding at March 31, 2007 with exercise prices less than or above \$19.0 per share (the closing price of the Company's Common Stock at March 31, 2007) is as follows:

Exercise Prices	Exercisable		Unexercisable		Total	
	Number of Shares/ SAR Units	Weighted Average Exercise Price	Number of Shares/ SAR Units	Weighted Average Exercise Price	Number of Shares/ SAR Units	Weighted Average Exercise Price
Less than \$19.0	824,716	\$ 15.03	41,991	\$ 18.44	866,707	\$ 15.20
Above \$19.0	2,827,053	\$ 26.12	4,023,853	\$ 24.45	6,850,906	\$ 25.14
<b>Total</b>	<b>3,651,769</b>	<b>\$ 23.61</b>	<b>4,065,844</b>	<b>\$ 24.39</b>	<b>7,717,613</b>	<b>\$ 24.02</b>

The Company's aggregate compensation cost for the three months ended March 31, 2007 and 2006 totaled \$4,154 and \$2,493, respectively. The total income tax benefit recognized in the income statement related to the Company's equity based compensation awards for the three months ended March 31, 2007 and 2006, was \$185 and \$87, respectively.

As of March 31, 2007, there was \$19,408 of total unrecognized compensation cost related to unvested equity-based compensation awards granted under the Company's stock option plans. This amount is expected to be recognized over the period from 2007 through 2011.

**NOTE L NEW ACCOUNTING PRONOUNCEMENTS**

In September 2006, the FASB issued Statement of Financial Accounting Standard No. 157, Fair Value Measurements (SFAS No. 157), which defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles, and expands disclosures about fair value measurements. SFAS No. 157 applies to other accounting pronouncements that require or permit fair value measurements. SFAS No. 157 is effective for financial statements issued for fiscal years beginning after November 15, 2007 and interim periods thereafter. The Company is currently assessing the impact of SFAS No. 157 on its consolidated financial position and results of operations.

In February 2007, the FASB issued SFAS No. 159, The Fair Value Option for Financial Assets and Financial Liabilities (SFAS No. 159). SFAS No. 159 permits entities to choose to measure many financial assets and financial liabilities at fair value. Unrealized gains and losses on items for which the fair value option has been elected are reported in earnings. SFAS No. 159 is effective for fiscal years beginning after November 15, 2007. The Company is currently assessing the impact of SFAS No. 159 on its consolidated financial position and results of operations.

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**ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS**

*The discussions in this Quarterly Report on Form 10-Q should be read in conjunction with our accompanying financial statements and the related notes thereto. This Quarterly Report on Form 10-Q contains forward-looking statements within the safe harbor provisions of the Private Securities Litigation Reform Act of 1995, Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Exchange Act of 1934, as amended. All statements included or incorporated by reference in this Quarterly Report, other than statements that are purely historical, are forward-looking statements. Words such as anticipates, expects, intends, plans, believes, seeks, estimates and similar expressions also identify forward looking statements. The forward looking statements in this Quarterly Report on Form 10-Q are not guarantees of future performance and are subject to risks and uncertainties that could cause actual results to differ materially from the results contemplated by the forward looking statements and include, without limitation, statements regarding:*

*Our expectation that sales from 5.8GHz products and, to a lesser extent, 2.4GHz products, will continue to represent a significant percentage of our revenue for the remainder of 2007 and in future periods;*

*Our belief that our DECT and CoIP products will contribute to our revenue in 2007 and increase as a percentage of total revenues in 2007 as compared to 2006;*

*Our expectation that the CoIP project that was recently announced by Panasonic is expected to begin shipments in the second half of 2007;*

*Our belief that our future growth will be dependent on our success in expanding our presence in the European DECT market, and the general market deployment and acceptance of our DECT and CoIP products;*

*Our expectation that research and development costs will increase in absolute dollars in 2007;*

*Our expectation that our gross margin in second half of 2007 will be in the range of 40% to 42%; and*

*Our anticipation that our available cash and cash equivalents at March 31, 2007 should be sufficient to finance our operations for both the short and long term.*

*All forward-looking statements included in this Quarterly Report on Form 10-Q are made as of the date hereof, based on information available to us as of the date hereof, and we assume no obligation to update any forward-looking statement. Many factors may cause actual results to differ materially from those expressed or implied by the forward-looking statements contained in this report. These factors include, but are not limited to, our dependence on one primary distributor, our OEM relationships and competition, as well as those risks described in Part II Item 1A Risk Factors of this Form 10-Q.*

**Overview**

The following discussion and analysis is intended to provide an investor with a narrative of our financial results and an evaluation of our financial condition and results of operations. The discussion should be read in conjunction with our consolidated financial statements and notes thereto.

Our business model is relatively straightforward. DSP Group is a fabless semiconductor company that is a leader in providing chipsets to telephone equipment and design manufacturers (OEMs and ODMs) for incorporation into consumer products for the short-range residential wireless communications market. Our chipsets incorporate advanced technologies, such as DSP processors, communications technologies, highly advanced radio frequency (RF) devices and in-house developed Cordless-over-Internet-Protocol (CoIP) hardware and software technologies. Our products include 1.9GHz (Digital Enhanced Cordless Telephony (DECT)), 2.4GHz and 5.8GHz chipsets for cordless

telephones, Bluetooth

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for voice, data and video communication, solutions for digital voice recorders and VoIP and other voice-over-packet applications. Our current primary focus is digital cordless telephony with sales of our CoIP, DECT, 2.4GHz and 5.8GHz chipsets representing approximately 84% of our total revenues for the first quarter of 2007.

In recent years we have become a worldwide leader in developing and marketing Total Telephony Solutions for the wireless residential market. We believe we were able to penetrate the residential wireless telephony market and increase our market share and customer base by taking advantage of the market transformation from analog-based to digital-based technologies for telephony products, the earlier shift from 900MHz to 2.4GHz technologies, and the shift from 2.4GHz to 5.8GHz technologies. Our focus on the convergence of these trends has allowed us to offer products with more features, and better range, security and voice quality. Another factor that contributed to our growth in recent years is our focus on new emerging markets such as the Japanese domestic market and the DECT market. An additional factor that contributed significantly to our revenue growth over the past few years is the market acceptance of our multi-handset solutions for cordless telephony. In recognition of the need to penetrate new markets and introduce new products to further expand our business, we decided to penetrate the DECT market, introducing our first DECT products for the European market in late 2004. Revenues derived from the sale of DECT products represented 16% of our revenues for the first quarter of 2007. In addition to the sale of DECT products, sales of our CoIP products, which we also consider to be a key product line with respect to our 2007 revenues, increased significantly during the first quarter of 2007 and exceeded our combined revenues for all three quarters of CoIP sales in 2006. We believe our future growth will be dependent on our success in expanding our presence in the European DECT market, and the general market deployment and acceptance of our DECT and CoIP products.

For the first quarter of 2007, our revenues decreased by 5% in comparison to 2006, reaching a level of \$49.3 million in sales. This decrease was mainly the result of decreased sales of our 2.4GHz products, partially offset by increased sales of our 5.8GHz, DECT and CoIP products. Our gross margin decreased to a level of 39% of total revenues for the first quarter of 2007 from 41% for the first quarter of 2006, primarily due to the continued decline in the average selling prices of our products. Operating expenses increased by 17% in 2007 compared to 2006, reaching a level of \$20.6 million. The increase in operating expenses was mainly the result of an increase in expenses related to equity-based compensation resulting from the implementation of Statement of Financial Accounting Standards No. 123(R), Share-Based Payment ( SFAS 123(R) ). Equity-based compensation expense (net of tax benefit) amounted to \$4.0 million for the first quarter of 2007 as compared to \$2.4 million for the same period in 2006. The increase also was the result of an increase in salary and labor expenses related to research and development for the first quarter of 2007 as compared to the same period in 2006. Our operating loss was \$1.3 million for the first quarter of 2007, approximately 2.6% of revenues, compared to \$4.1 million operating profit for the same period in 2006, representing 8% of revenues. The operating loss for the first quarter of 2007 was primarily attributable to (i) an increase in expenses related to equity-based compensation under SFAS 123(R), (ii) the decline in revenues and gross margins, and (iii) the increase in salaries and labor expenses related to research and development. As of March 31, 2007, our principal source of liquidity consisted of cash and cash equivalents totaling approximately \$35.2 million, short term investments of \$30.7 million and marketable securities of approximately \$289.4 million, totaling to \$355.3 million.

However, our business operates in a highly competitive environment. Competition has historically increased pricing pressures for our products and decreased our average selling prices. We expect pricing pressures relating to the average selling prices of our products to continue throughout 2007. In order to penetrate new markets and maintain our market share with our existing products, we may need to offer our products in the future at lower prices which may result in lower profits. Our future growth is dependent not only on the continued success of our existing products but also the successful introduction of new products. Also, since our products are incorporated into end products of original equipment manufacturer (OEM) customers, our business is very dependent on their ability to introduce products that achieve market acceptance in consumer electronic markets, which are equally competitive.

Moreover, we must continue to monitor and control our operating costs and our gross margins in order to offset future declines in average selling prices. In addition, as we are a fabless semiconductor company, global market trends such as over-capacity problems (shortage of capacity to meet our fabrication, testing and assembly needs) may increase

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our raw material and production costs and thus decrease our gross margins. Also, future increases in the pricing of silicon wafers and assembly or testing costs may affect our ability to implement cost reductions and may decrease our gross profit in future periods. Moreover, we are currently witnessing a move of manufacturing activities from large system suppliers in the U.S., Japan and Europe to Southeast Asia, a trend that also could adversely affect our business. In order to partially offset these factors, we are implementing cost improvement plans designed by our engineers to reduce the cost of testing, and offer our customers more cost effective products. We believe these measures will allow us to increase our gross margin to a range of 40% to 42% for the second half of 2007.

There are also several emerging market trends that challenge our continued business growth potential. We believe that new developments in the home residential market may adversely affect our operating results. For example, the rapid deployment of new communication access methods, including mobile, wireless broadband, cable and other connectivity, as well as the projected lack of growth in products using fixed-line telephony, may reduce our revenues derived from, and unit sales of, cordless telephony products, which are currently our primary focus. Our business may also be affected by the outcome of the current competition between cellular phone operators and fixed-line operators for the provision of residential communication. Our revenues are currently primarily generated from sales of chipsets used in cordless phones that are based on fixed-line telephony. As a result, a decline in the use of fixed-line telephony for residential communication would adversely affect our financial condition and operating results. Another factor that could affect the results of our operations is the potential shift in the U.S. digital telephony market towards DECT products as during 2006 the Federal Communications Commission (FCC) authorized the use of the DECT frequency band in the U.S. (DECT 6.0). The U.S. market is currently the dominant market for our customers. An increase in demand for DECT 6.0 products in the U.S. in lieu of our 2.4GHz and 5.8GHz products, and our inability to successfully develop and market new DECT 6.0 products to address this market may have a material adverse effect on our profits and results of operations.

We are taking several steps to address the new challenges and market trends. We are preparing for the deployment of broadband services to the residence, a current trend in our market. We currently are engaged in two projects with customers designing cordless phones that incorporate CoIP chipsets, one of which is with a large European operator whom we already have started shipments in 2006 and the other of which is with Panasonic and is expected to begin shipments in the second half of 2007. Moreover, we recently announced that during the first quarter of 2007 we achieved two new design wins with additional customers for our CoIP products.

We also are introducing new features into our existing products and are penetrating additional markets, including China, Korea, South America and the domestic Japanese market, with our existing products.

We believe our market is undergoing a transition whereby the residential communications technology, currently characterized mainly by wireless voice communication, is moving towards voice communication over IP networks and ultimately the convergence of voice, video and data communications. We believe that our DECT and CoIP products will contribute to our revenues in 2007 and increase as a percentage of total revenues in 2007 in comparison to 2006 as the present business environment reflects a continued decrease in sales of our 2.4GHz products and intense pricing pressures for our 5.8GHz products. Our long term goal is to leverage the Wi-Fi technology acquired in 2004 from Bermai Inc. to develop and offer products for home communication in future years. We believe the strategic acquisitions we made in 2003 and 2004 of various video and Wi-Fi technologies will enable us to integrate voice, data and video technologies with broadband offerings and prepare us for the dynamic and evolving nature of the short-range multimedia communication and home wireless markets.

However, our ability to introduce new products and expand into new markets may not occur and may require us to substantially increase our operating expenses. As a result, our past operating results should not be relied upon as an indication of future performance.

**Table of Contents****RESULTS OF OPERATIONS**

**Total Revenues.** Our total revenues were \$49.3 million for the first quarter of 2007 as compared to \$51.9 million for the same period in 2006. This decrease of 5% in 2007 was primarily as a result of a decrease in sales of our 2.4GHz products, partially offset by increased sales of our 5.8GHz, DECT and CoIP products. Sales of DECT products were \$7.9 million in the first quarter of 2007, representing 16% of total revenues. Sales of DECT product in the same period of 2006 were \$7.4 million, representing 14% of total revenues. Sales of 5.8GHz products represented approximately 40% and 36% of our total revenues for the first quarters of 2007 and 2006, respectively, representing an increase of 6% in absolute dollars. Sales of 2.4GHz products represented 21% and 30% of our total revenues for the first quarters of 2007 and 2006, respectively, representing a decrease of 34% in absolute dollars. As is typical in the semiconductor consumer industry, we experienced pricing pressures for our current products. However, the impact of the decline in average selling prices of our products was partially offset by an increase in the number of units sold for the same period. We cannot provide any assurances, however, that we will be able to offset future declines in average selling prices with an increase in the number of units sold.

The following table shows the breakdown of revenues for the periods indicated by geographic location (in thousands):

	<b>Period Ended March 31,</b>	
	<b>2007</b>	<b>2006</b>
United States	\$ 151	\$ 125
Japan	\$ 34,520	\$ 35,408
Europe	\$ 76	\$ 311
Hong Kong	\$ 12,761	\$ 13,628
Other	\$ 1,780	\$ 2,480
 Total revenues	 \$ 49,288	 \$ 51,952

As our products are generally incorporated into consumer products sold by our OEM customers, our revenues are affected by seasonal buying patterns of consumer products sold by our OEM customers that incorporate our products. The fourth quarter in any given year is usually the strongest quarter of sales for our OEM customers and, as a result, the third quarter in any given year is usually the strongest quarter for our revenues as our OEM customers request increased shipments of our products in anticipation of the fourth quarter holiday season. This trend can be generally observed from reviewing our quarterly information and results of operations. However, the magnitude of this trend varies annually.

**Significant Customers.** Revenues derived from sales through one distributor, Tomen Electronics Corporation ( Tomen Electronics ), accounted for 49% of our total revenues for the first quarter of 2007 as compared to 68% for the same period in 2006. The decrease was primarily due to a shift from sales to one of our significant customers through Tomen for most of 2006 to direct sales to that customer in 2007.

The Japanese market and the OEMs that operate in that market are among the largest suppliers of residential wireless products with significant market share in the U.S. market. Tomen Electronics sells our products to a limited number of customers. One customer, Panasonic Communications Co., Ltd., ( Panasonic ), has continually accounted for a majority of the sales through Tomen Electronics. Sales to Panasonic through Tomen Electronics generated approximately 31% and 44% of our revenues for the three months ended March 31, 2007 and 2006, respectively. The loss of Tomen Electronics as a distributor and our inability to obtain a satisfactory replacement in a timely manner would harm our sales and results of operations. Additionally, the loss of Panasonic and Tomen Electronics' inability to thereafter effectively market our products would also harm our sales and results of operations.

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Sales through Tomen Electronics or directly to Uniden represented 22% and 17% of our total revenues for the three months ended March 31, 2007 and 2006, respectively. In addition sales to Hong Kong-based CCT Telecom represented 12% and 16% of total revenues for the three months ended March 31, 2007 and 2006, respectively, and sales to Hong Kong-based SunCorp represented 13% and 9% of total revenues for the three months ended March 31, 2007 and 2006, respectively.

**Significant Products.** Sales from our 5.8GHz and 2.4GHz digital products represented 40% and 21%, respectively, of total revenues for the first quarter of 2007. We believe that sales of 5.8GHz digital products and, to a lesser extent, 2.4GHz digital products will continue to represent a substantial percentage of our revenues for the remainder of 2007 and in future periods. For the long-term, we believe that the rapid deployment of new communication access methods, as well as the projected lack of growth in fixed-line telephony, will reduce our total revenues derived from, and unit sales of, cordless telephony products, including future sales of our 2.4GHz and 5.8GHz products. Revenues from our DECT and CoIP products represented 16% and 7%, respectively, of total revenues for the first quarter of 2007.

**Gross Profit.** Gross profit as a percentage of revenues was 39% for the first quarter of 2007 and 42% for the first quarter of 2006. The decrease in our gross profit was primarily due to the continuing decline in the average selling prices of our products and to the difference in mix of products between comparable periods.

Our gross profit may decrease further in the future due to a variety of factors, including the continued decline in the average selling prices of our products, our failure to achieve the corresponding cost reductions, roll-out of new products in any given period and our failure to introduce new engineering processes. We cannot guarantee that our ongoing efforts in cost reduction and yield improvements will be successful or that they will keep pace with the anticipated continuing decline in average selling prices of our products. Future increases in the pricing of silicon wafers or other production costs, such as testing and assembly, may affect our ability to implement cost reductions and may decrease our gross profit in future periods. As we are a fabless company, global market trends such as over-capacity problems (shortage of capacity to meet our fabrication, testing and assembly needs) may also increase our raw material costs and decrease our gross profit. One approach we are using to offset the expected decrease in gross margins is to offer our customers bare-die chips that eliminate assembly and testing services in return for lower selling prices to our customers. Other steps we are taking include the implementation of cost improvement plans designed by our engineers to reduce cost of testing and offer our customers more cost effective products. However, we can provide no assurances that this solution will be accepted by our customers or that it will help us offset the expected decrease in gross margins.

As gross profit reflects the sale of chips and chipsets that have different margins, changes in the mix of products sold have impacted and will continue to impact our gross profit in future periods. Moreover, penetration of new competitive markets, such as the European DECT market, could require us to reduce sale prices of our products or increase the cost per product and thus reduce our total gross profit in future periods.

Cost of goods sold consists primarily of costs of wafer manufacturing and fabrication, assembly and testing of integrated circuit devices and related overhead costs, and compensation and associated expenses relating to manufacturing and testing support and logistics personnel.

**Research and Development Expenses.** Our research and development expenses increased to \$12.8 million for the first quarter of 2007 from \$10.9 million for the first quarter of 2006. The increase in 2007 was primarily attributed to an increase in expenses related to equity-based compensation resulting from the adoption of SFAS 123(R). Equity-based compensation expenses amounted to \$2.1 million for the first quarter of 2007 as compared to \$1.2 million for the first quarter of 2006. The increase in research and development expenses was also a result of an increase in salary and labor expenses for the first quarter of 2007 as compared with the same period in 2006.

Our research and development expenses as a percentage of total revenues were 26% for the three months ended March 31, 2007 and 21% for the three months ended March 31, 2006. This increase in research and development expenses as a percentage of total revenues was due to the decrease in revenues along with the increase absolute dollars of the research and development expenses.

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As our research and development staff is currently working on various projects simultaneously, we may need to incur additional expenses and hire additional research and development staff and contractors related to the development of new products and to support the development of existing products and technologies. As a result, our research and development expenses in absolute dollars are expected to increase for the remaining quarters of 2007.

Research and development expenses consist mainly of payroll expenses to employees involved in research and development activities, expenses related to tape-out and mask work, subcontracting, labor contractors and engineering expenses, depreciation and maintenance fees related to equipment and software tools used in research and development, and facilities expenses associated with and allocated to research and development activities.

***Sales and Marketing Expenses.*** Our sales and marketing expenses increased to \$4.2 million for the first quarter of 2007 from \$3.8 million for the first quarter of 2006. This increase was attributed mainly to higher levels of salary expenses mainly due to a greater number of sales and marketing employees. The increase is also a result of increase in expenses related to equity-based compensation resulting from the adoption of SFAS 123(R). Equity-based compensation expenses amounted to \$0.4 million for the first quarter of 2007 as compared to \$0.3 million for the first quarter of 2006. The increase in our sales and marketing expenses was partially offset by a decrease in commission paid to our sales representatives due to lower level of revenues for the first quarter of 2007 and a decrease in the average commission paid to our sales representatives.

Our sales and marketing expenses as a percentage of total revenues were 9% and 7% for the three months ended March 31, 2007 and 2006, respectively. This increase in sales and marketing expenses as a percentage of total revenues was due to the decrease in revenues along with the increase in absolute dollars of the sales and marketing expenses.

Sales and marketing expenses consist mainly of sales commissions to our representatives and distributors, payroll expenses to direct sales and marketing employees, travel, trade show expenses, and facilities expenses associated with and allocated to sales and marketing activities.

***General and Administrative Expenses.*** Our general and administrative expenses were \$3.6 million for the three months ended March 31, 2007, as compared to \$2.8 million for the three months ended March 31, 2006. The increase was attributed mainly to an increase in equity-based compensation expenses related to the adoption of SFAS 123(R) that amounted to \$1.5 million for the first quarter of 2007 as compared to \$0.9 million for the first quarter of 2006. One additional factor that increased general and administrative expenses was higher legal and accounting expenses for the first quarter of 2007 as compared to 2006.

General and administrative expenses as a percentage of total revenues were 7% and 5% for the first quarters of 2007 and 2006. This increase in general and administrative expenses as a percentage of total revenues was due to the decrease in revenues along with the increase in absolute dollars of the general and administrative expenses.

General and administrative expenses consist mainly of payroll for management and administrative employees, accounting and legal fees, expenses related to investor relations as well as facilities expenses associated with general and administrative activities.

***Interest and Other Income, net.*** Interest and other income, net, for the three months ended March 31, 2007 increased to \$3.7 million from \$3.1 million for the three months ended March 31, 2006. The increase was due to overall higher market interest rates during the three months ended March 31, 2007, as compared to the same period in 2006. Our total cash, cash equivalents and marketable securities were \$355.3 million as of March 31, 2007, compared to \$374.9 million as of March 31, 2006. The decrease was primarily due to the use of cash for stock repurchases during 2006.



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***Provision for Income Taxes.*** Our income tax expenses were \$1 million and \$1.6 million for the three months ended March 31, 2007 and 2006, respectively. The provision for income taxes as a percentage of income before taxes was 43% and 22% for the three months ended March 31, 2007 and 2006, respectively. The increase in the provision for income taxes as a percentage of pretax income for the first quarter of 2007 was mainly the result of an increase in expenses related to SFAS 123(R), which expenses were associated mainly with our Israeli employees and were not deductible for tax purposes. Tax benefit related to the expensing of equity-based compensation amounted to \$0.2 million for the three months ended March 31, 2007 as compared to \$0.1 million for the three months ended March 31, 2006.

In 2007 and 2006, we benefited for tax purposes from foreign tax holiday and tax-exempt income in Israel. DSP Group Ltd., our Israeli subsidiary, was granted Approved Enterprise status by the Israeli government with respect to six separate investment plans. Approved Enterprise status allows our Israeli subsidiary to enjoy a tax holiday for a period of two to four years and a reduced corporate tax rate of 10%-25% for an additional six or eight years, on each investment plan's proportionate share of taxable income. The tax benefits under these investment plans are scheduled to gradually expire by 2015.

On April 1, 2005, an amendment to the Israeli Investment Law came into effect. The amendment revised the criteria for investments qualified to receive tax benefits. An eligible investment program under the amendment will qualify for benefits as a Privileged Enterprise (rather than the previous terminology of Approved Enterprise). Among other things, the amendment provides tax benefits to both local and foreign investors and simplified the approval process. The amendment does not apply to investment programs approved prior to December 31, 2004. The new tax regime will apply to new investment programs only. We believe that we are currently in compliance with these requirements. However, if we fail to meet these requirements, we would be subject to corporate tax in Israel at the regular statutory rate (29% for 2007). We could also be required to refund tax benefits, with interest and adjustments for inflation based on the Israeli consumer price index. As of January 1, 2007, we started to generate income under the provision of the amendment.

***Equity-Based Compensation Expense.*** On January 1, 2006, we adopted SFAS 123(R) which requires the measurement and recognition of compensation expense for all equity-based payment awards made to our employees and directors, including employee stock options and employee stock purchases, based on estimated fair values. Equity-based compensation expense recognized under SFAS 123(R) for the three months ended March 31, 2007 and 2006 were \$4.2 million and \$2.5 million, respectively. Upon adoption of SFAS 123(R), we also changed our method of valuation for equity-based awards granted beginning in fiscal 2006 to an exercise multiple-based lattice option-pricing model (EMLM /binomial model) from the Black-Scholes option-pricing model (Black-Scholes model) which was previously used for our presentation of pro forma information required under SFAS 123. The use of EMLM model requires various judgmental assumptions, including estimating stock price volatility, forfeiture rates and exercise behavior. In addition, we consider many factors when estimating expected forfeitures and expected life, including types of awards, employee class, and historical experience. If any of the assumptions used in the EMLM model change significantly, equity-based compensation expense may differ materially in the future from that recorded in the current period. See Note K to the Notes to the Condensed Consolidated Financial Statements for additional information.

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**LIQUIDITY AND CAPITAL RESOURCES**

**Operating Activities.** Our cash flows from operating activities were \$7.1 million and \$4.1 million for the first quarters of 2007 and 2006, respectively. The increase in net cash provided by operating activities in the first quarter of 2007 as compared to the same period in 2006 resulted mainly from the decrease in inventory by \$1.7 million during the first quarter of 2007 compared with an increase in inventory of \$3.2 million during the first quarter of 2006. The increase in cash from operating activities was also a result of the decrease in accrued compensation and benefits by \$2.0 million and \$3.8 million for the first quarters of 2007 and 2006, respectively, due to the payment of annual bonuses to our executive officers and employees. This was partially offset by the decrease in net income for the comparable periods.

**Investing Activities.** We invest excess cash in marketable securities of varying maturity, depending on our projected cash needs for operations, capital expenditures and other business purposes. During the first three months of 2007, we purchased \$49.3 million of investments classified as held-to-maturity marketable securities, bank deposits and auction rate securities, as compared to \$23.4 million during the first three months of 2006. During the same periods, \$40.3 million and \$10.5 million, respectively, of investments classified as held-to-maturity marketable securities matured.

Our capital equipment purchases for the first three months of 2007, consisting primarily of research and development software tools, computers and other peripheral equipment, totaled \$1.2 million, as compared to \$0.8 million for the first three months of 2006.

**Financing Activities.** During the first quarter of 2007, we received \$0.9 million upon the exercise of employee stock options, as compared to \$26.6 million during the first quarter of 2006. We cannot predict cash flows from option exercises and employee stock purchases for future periods.

In March 1999, our board of directors authorized the repurchase of up to an aggregate of 4.0 million shares of our common stock, which authorization was increased by an additional 2.5 million shares of our common stock in July 2003, 2.5 million additional shares in October 2004, and 3.0 million additional shares in January 2007. Based on these authorizations, approximately 3.8 million shares to our common stock remain authorized for repurchase as of March 31, 2007.

In March 31, 2007, we had cash and cash equivalents totaling approximately \$35.2 million, short term investments of \$30.7 million and marketable securities of approximately \$289.4 million.

Our working capital at March 31, 2007 was approximately \$167.1 million. As we generate most of our cash flows from our operating activities, we believe that our current cash, cash equivalents, cash deposits and marketable securities and our forecasted positive cash flows for future periods, will be sufficient to meet our cash requirements for both the short and long term.

In addition, as part of our business strategy, we occasionally evaluate potential acquisitions of businesses, products and technologies. Accordingly, a portion of our available cash may be used at any time for the acquisition of complementary products or businesses. Such potential transactions may require substantial capital resources, which may require us to seek additional debt or equity financing. We cannot assure you that we will be able to successfully identify suitable acquisition candidates, complete acquisitions, integrate acquired businesses into our current operations, or expand into new markets. Furthermore, we cannot assure you that additional financing will be available to us in any required time frame and on commercially reasonable terms, if at all. See Risk Factors We may engage in future acquisitions that could dilute our stockholders' equity and harm our business, results of operations and financial condition. for more detailed information.

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### ***Off-Balance Sheet Arrangements***

We do not have any off-balance sheet arrangements, as such term is defined in recently enacted rules by the Securities and Exchange Commission, that have or are reasonably likely to have a current or future effect on our financial condition, changes in financial condition, revenues or expenses, results of operations, liquidity, capital expenditures or capital resources that are material to investors.

### **QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK**

***Interest Rate Risk.*** It is our policy not to enter into interest rate derivative financial instruments, except for hedging of foreign currency exposures discussed below. We do not currently have any significant interest rate exposure since we do not have any financial obligation, and our financial assets are measured on a held-to-maturity basis.

***Foreign Currency Exchange Rate Risk.*** As a significant part of our sales and expenses are denominated in U.S. dollars, we have experienced only insignificant foreign exchange gains and losses to date, and do not expect to incur significant gains and losses in 2007. However, due to the volatility in the exchange rate of the NIS versus the U.S. dollar, we decided to hedge part of the risk of a devaluation of the NIS, which could have an adverse effect on the expenses that we incur in the State of Israel. For example, to partially protect against an increase in value of forecasted foreign currency cash flows resulting from salary payments and lease payments for our Israeli facilities denominated in NIS during 2007 we instituted a foreign currency cash flow hedging program.

These option and forward contracts are designated as cash flow hedges, as defined by SFAS No. 133, *Accounting for Derivative Instruments and Hedging Activities*, and are all effective as hedges of these expenses. For more information about our hedging activity, see Note G to the attached Notes to the Condensed Consolidated Financial Statement for the period ended March 31, 2007.

### **ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURE ABOUT MARKET RISK**

See *Management's Discussion and Analysis of Financial Condition and Results of Operations* Quantitative and Qualitative Disclosures about Market Risk.

### **ITEM 4. CONTROLS AND PROCEDURES**

As of the end of the period covered by this report, we carried out an evaluation, under the supervision and with the participation of our Chief Executive Officer and Chief Financial Officer, of the effectiveness of the design and operation of our disclosure controls and procedures. Based on this evaluation, our Chief Executive Officer and Chief Financial Officer concluded that our disclosure controls and procedures are effective in timely alerting them to material information required to be included in this report.

There has been no change in our internal control over financial reporting that occurred during our most recent fiscal quarter that has materially affected or is reasonably likely to materially affect our internal control over financial reporting.

## **PART II. OTHER INFORMATION**

### **ITEM 1. LEGAL PROCEEDINGS.**

From time to time, we may become involved in litigation relating to claims arising from our ordinary course of business activities. Also, as is typical in the semiconductor industry, we have been and may from time to time be notified of claims that we may be infringing patents or intellectual property rights owned by third parties. For example, in a

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lawsuit against Microsoft Corporation, AT&T asserted that our TrueSpeech 8.5 algorithm includes certain elements covered by a patent held by AT&T. AT&T sued Microsoft, one of our TrueSpeech 8.5 licensees, for infringement. We were not named in AT&T's suit against Microsoft. We currently believe that there are no claims or actions pending or threatened against us, the ultimate disposition of which would have a material adverse effect on us.

**ITEM 1A. RISK FACTORS.**

*This Form 10-Q contains forward-looking statements concerning our future products, expenses, revenue, liquidity and cash needs as well as our plans and strategies. These forward-looking statements are based on current expectations and we assume no obligation to update this information. Numerous factors could cause our actual results to differ significantly from the results described in these forward-looking statements, including the following risk factors.*

There are no material changes to the Risk Factors described under the title "Factors That May Affect Future Performance" in our Annual Report on Form 10-K for the fiscal year ended December 31, 2006 other than (1) changes to the Risk Factor below entitled "We rely on a primary distributor for a significant portion of our total revenues and the failure of this distributor to perform as expected would materially reduce our future sales and revenues"; (2) changes to the Risk Factor below entitled "We rely significantly on revenue derived from a limited number of customers"; (3) changes to the Risk Factor below entitled "We generate a significant amount of our total revenues from the sale of Integrated Digital Telephony (IDT) products and our business and operating results may be materially adversely affected if we do not continue to succeed in the highly competitive IDT market"; (4) changes to the Risk Factor below entitled "Our gross margins and profitability may be materially adversely affected by the continued decline in average selling prices of our products and other factors, including increases in assembly and testing expenses"; (5) changes to the Risk Factor below entitled "In order to sustain the future growth of our business, we must penetrate new markets and our new products, such as our DECT products, must achieve widespread market acceptance"; (6) changes to the Risk Factor below entitled "Because we have significant operations in Israel, we may be subject to political, economic and other conditions affecting Israel that could increase our operating expenses and disrupt our business"; and (7) changes to the Risk Factor below entitled "The tax benefits available to us under Israeli law require us to meet several conditions, and may be terminated or reduced in the future, which would increase our taxes.

***We rely on a primary distributor for a significant portion of our total revenues and the failure of this distributor to perform as expected would materially reduce our future sales and revenues.***

We sell our products to customers primarily through a network of distributors and original equipment manufacturer (OEM) representatives. Particularly, revenues derived from sales through our Japanese distributor, Tomen Electronics, accounted for 49% and 68% of our total revenues for the three months ended March 31, 2007 and 2006 respectively. Our future performance will depend, in part, on this distributor to continue to successfully market and sell our products. Furthermore, Tomen Electronics sells our products to a limited number of customers. One customer, Panasonic Communications Co., Ltd., has continually accounted for a majority of the sales through Tomen Electronics. Sales to Panasonic through Tomen Electronics generated approximately 31% and 44% of our revenues for the three months ended March 31, 2007 and 2006, respectively. The loss of Tomen Electronics as our distributor and our inability to obtain a satisfactory replacement in a timely manner would materially harm our sales and results of operations. Additionally, the loss of Panasonic and Tomen Electronics' inability to thereafter effectively market our products would also materially harm our sales and results of operations.

***We rely significantly on revenue derived from a limited number of customers.***

We expect that a limited number of customers, varying in identity from period-to-period, will account for a substantial portion of our revenues in any period. Our four largest customers—Panasonic, Uniden, CCT and SunCorp—derived from sales through Tomen Electronics or directly to the customers, accounted for 78% and 86% of total revenues for the three months ended March 31, 2007 and 2006, respectively. In addition to Panasonic mentioned above, sales to Uniden represented 22% and 17% of total revenues for the three months ended March 31, 2007 and 2006, respectively;

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sales to Hong Kong-based CCT Telecom represented 12% and 16% of total revenues for the three months ended March 31, 2007 and 2006, respectively; and sales to Hong Kong-based SunCorp represented 13% and 9% of total revenues for the three months ended March 31, 2007 and 2006, respectively. Typically, our sales are made on a purchase order basis, and none of our customers has entered into a long-term agreement requiring it to purchase our products. Moreover, we do not typically require our customers to purchase a minimum quantity of our products, and our customers can generally cancel or significantly reduce their orders on short notice without significant penalties. A significant amount of our revenues will continue to be derived from a limited number of large customers. The loss of or reduced demand for products from any of our major customers could have a material adverse effect on our business, financial condition and results of operations.

***Because our products are components of end products, if OEMs do not incorporate our products into their end products or if the end products of our OEM customers do not achieve market acceptance, we may not be able to generate adequate sales of our products.***

Our products are not sold directly to the end-user; rather, they are components of end products. As a result, we rely upon OEMs to incorporate our products into their end products at the design stage. Once an OEM designs a competitor's product into its end product, it becomes significantly more difficult for us to sell our products to that customer because changing suppliers involves significant cost, time, effort and risk for the customer. As a result, we may incur significant expenditures on the development of a new product without any assurance that an OEM will select our product for design into its own product and without this design win it becomes significantly difficult to sell our products. Moreover, even after an OEM agrees to design our products into its end products, the design cycle is long and may be delayed due to factors beyond our control which may result in the end product incorporating our products not to reach the market until long after the initial design win with the OEM. From initial product design-in to volume production, many factors could impact the timing and/or amount of sales actually realized from the design-in. These factors include, but are not limited to, changes in the competitive position of our technology, our customers financial stability, and our ability to ship products according to our customers' schedule.

Furthermore, we rely on the end products of our OEM customers that incorporate our products to achieve market acceptance. Many of our OEM customers face intense competition in their markets. If end products that incorporate our products are not accepted in the marketplace, we may not achieve adequate sales volume of our products, which would have a negative effect on our results of operations.

***We generate a significant amount of our total revenues from the sale of digital cordless telephony products and our business and operating results may be materially adversely affected if we do not continue to succeed in this highly competitive market.***

Sales of our digital cordless telephony products comprised a majority of our total revenues for the first quarter of 2007. Specifically, sales of our 2.4GHz, 5.8GHz, DECT and CoIP products comprised 84% and 80% of our total revenues for the first quarters of 2007 and 2006, respectively. Sales of our 5.8GHz and 2.4GHz products represented 40% and 21%, respectively, of our total revenues for the first quarter of 2007, and 36% and 30%, respectively, of our total revenues for the first quarter of 2006. We expect that our 5.8GHz products and, to a lesser extent, our 2.4GHz products, will continue to account for a substantial portion of our revenues for the remainder of 2007 and future years. As a result, any adverse change in the digital cordless market or in our ability to compete and maintain our competitive position in that market would harm our business, financial condition and results of operations. The digital cordless telephony market is extremely competitive, and we expect that competition will only increase. Our existing and potential competitors in each of our markets include large and emerging domestic and foreign companies, many of which have significantly greater financial, technical, manufacturing, marketing, sale and distribution resources and management expertise than we do. It is possible that we may one day be unable to respond to increased price competition for digital cordless telephony processors or other products through the introduction of new products or reduction of manufacturing costs. This inability would have a material adverse effect on our business, financial condition and results of operations. Likewise, any significant delays by us in developing, manufacturing or shipping new or enhanced products in this market also would have a material adverse effect on our business, financial condition and results of operations.

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Moreover, in recent years, we benefited from the shift from analog-based to digital-based systems. The erosion of this trend or alternatively a reverse shift from digital-based to analog-based systems could materially adversely affect our revenues.

In addition, we believe new developments in the home residential market may adversely affect the revenues we derive from our digital cordless telephony products. For example, the rapid deployment of new communication access methods, including mobile, wireless broadband, cable and other connectivity, may reduce the market for products using fixed-line telephony. This decrease in demand would reduce our revenues derived from, and unit sales of, our digital cordless telephony products.

***Because our quarterly operating results may fluctuate significantly, the price of our common stock may decline.***

Our quarterly results of operations may vary significantly in the future for a variety of reasons, many of which are outside our control, including the following:

fluctuations in volume and timing of product orders;

changes in demand for our products due to seasonal consumer buying patterns and other factors;

timing of new product introductions by us, including our DECT and CoIP products, and by our customers or competitors;

changes in the mix of products sold by us or our competitors;

fluctuations in the level of sales by our OEM customers and other vendors of end products incorporating our products;

timing and size of expenses, including expenses to develop new products and product improvements;

entry into new markets, including China, Korea, South America and the domestic Japanese market;

mergers and acquisitions by us, our competitors and our existing and potential customers; and

general economic conditions, including the changing economic conditions in the United States and worldwide.

Each of the above factors is difficult to forecast and could harm our business, financial condition and results of operations. Also, we sell our products to OEM customers that operate in consumer markets. As a result, our revenues are affected by seasonal buying patterns of consumer products sold by our OEM customers that incorporate our products and the market acceptance of such products supplied by our OEM customers. The fourth quarter in any given year is usually the strongest quarter for sales by our OEM customers in the consumer markets, and thus, our third quarter in any given year is usually the strongest quarter for revenues as our OEM customers request increased shipments of our products in anticipation of the increased activity in the fourth quarter. By contrast, the first quarter in any given year is usually the weakest quarter for us.

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***Our gross margins and profitability may be materially adversely affected by the continued decline in average selling prices of our products and other factors, including increases in assembly and testing expenses.***

We have experienced and will continue to experience a decrease in the average selling prices of our products. Decreasing average selling prices could result in decreased revenues even if the volume of products sold increases. Decreasing average selling prices may also require us to sell our products at much lower gross margin than in the past and reduce profitability. Although we have to date been able to partially offset on an annual basis the declining average selling prices through manufacturing cost reductions by achieving a higher level of product integration and improving our yield percentages, there is no guarantee that our ongoing efforts will be successful or that they will keep pace with the anticipated, continued decline in average selling prices of our products. As an example, our gross margin for the first quarter of 2007 was 39%. In addition to the continued decline in the average selling prices of our products, our gross profit may decrease in the future due to other factors, including the roll-out of new products in any given period and the penetration of new markets which may require us to sell products at a lower margin, our failure to introduce new engineering processes, mix of products sold, increases in the pricing of silicon wafers, and increases in other production costs, including testing and assembly. Furthermore, as we are a fabless company, global market trends such as over-capacity problems so that there is a shortage of capacity to fulfill our fabrication needs also may increase our raw material costs and thus decrease our gross margin.

***Because we depend on independent foundries to manufacture all of our integrated circuit products, we are subject to additional risks that may materially disrupt our business.***

All of our integrated circuit products are manufactured by independent foundries. While these foundries have been able to adequately meet the demands of our increasing business, we are and will continue to be dependent upon these foundries to achieve acceptable manufacturing yields, quality levels and costs, and to allocate to us a sufficient portion of their foundry capacity to meet our needs in a timely manner.

While we currently believe we have adequate capacity to support our current sales levels pursuant to our arrangement with our foundries, we may encounter capacity shortage issues in the future. In the event of a worldwide shortage in foundry capacity, we may not be able to obtain a sufficient allocation of foundry capacity to meet our product needs or we may incur additional costs to ensure specified quantities of products and services. Over-capacity at the current foundries we use, or future foundries we may use, to manufacture our integrated circuit products may lead to increased operating costs and lower gross margins. In addition, such a shortage could lengthen our products' manufacturing cycle and cause a delay in the shipment of our products to our customers. This could ultimately lead to a loss of sales of our products, harm our reputation and competitive position, and our revenues could be materially reduced. Our business could also be harmed if our current foundries terminate their relationship with us and we are unable to obtain satisfactory replacements to fulfill customer orders on a timely basis and in a cost-effective manner.

In addition, as TSMC produces a significant portion of our integrated circuit products and ASE tests and assembles them, earthquakes, aftershocks or other natural disasters in Asia, or adverse changes in the political situation in Taiwan, could preclude us from obtaining an adequate supply of wafers to fill customer orders. Such events could harm our reputation, business, financial condition, and results of operations.

***Because the manufacture of our products is complex, the foundries on which we depend may not achieve the necessary yields or product reliability that our business requires.***

The manufacture of our products is a highly complex and precise process, requiring production in a highly controlled environment. Changes in manufacturing processes or the inadvertent use of defective or contaminated materials by a foundry could adversely affect the foundry's ability to achieve acceptable manufacturing yields and product reliability. If the foundries we currently use do not achieve the necessary yields or product reliability, our ability to fulfill our customers' needs could suffer. This could ultimately lead to a loss of sales of our products and have a negative effect on our gross margins and results of operations.

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Furthermore, there are other significant risks associated with relying on these third-party foundries, including:

risks due to the fact that we have reduced control over production cost, delivery schedules and product quality;

less recourse if problems occur as the warranties on wafers or products supplied to us are limited; and

increased exposure to potential misappropriation of our intellectual property.

***As we depend on independent subcontractors, located in Asia, to assemble and test our semiconductor products, we are subject to additional risks that may materially disrupt our business.***

Independent subcontractors, located in Asia, assemble and test our semiconductor products. Because we rely on independent subcontractors to perform these services, we cannot directly control our product delivery schedules or quality levels. Our future success also depends on the financial viability of our independent subcontractors. If the capital structures of our independent subcontractors weaken, we may experience product shortages, quality assurance problems, increased manufacturing costs, and/or supply chain disruption.

Moreover, the economic, market, social, and political situations in countries where some of our independent subcontractors are located are unpredictable, can be volatile, and can have a significant impact on our business because we may not be able to obtain product in a timely manner. Market and political conditions, including currency fluctuation, terrorism, political strife, war, labor disruption, and other factors, including natural or man-made disasters, adverse changes in tax laws, tariff, import or export quotas, power and water shortages, or interruption in air transportation, in areas where our independent subcontractors are located also could have a severe negative impact on our operating capabilities.

***Because we have significant international operations, we may be subject to political, economic and other conditions relating to our international operations that could increase our operating expenses and disrupt our business.***

Although the majority of end users of the consumer products that incorporate our products are located in the U.S., we are dependent on sales to OEM customers, located outside of the U.S., that manufacture these consumer products. We expect that international sales will continue to account for a significant portion of our net product sales for the foreseeable future. For example, export sales, primarily consisting of digital cordless telephony products shipped to manufacturers in Europe and Asia, including Japan and Asia Pacific, represented 100% of our total revenues for the first quarter of 2007. As a result, the occurrence of any negative international political, economic or geographic events could result in significant revenue shortfalls. These shortfalls could cause our business, financial condition and results of operations to be harmed. Some of the risks of doing business internationally include:

unexpected changes in regulatory requirements;

fluctuations in the exchange rate for the United States dollar;

imposition of tariffs and other barriers and restrictions;

burdens of complying with a variety of foreign laws;

political and economic instability; and



changes in diplomatic and trade relationships.

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***In order to sustain the future growth of our business, we must penetrate new markets and our new products, such as our DECT products, must achieve widespread market acceptance.***

In order to increase our sales volume and expand our business, we must penetrate new markets and introduce new products. We are exploring opportunities to expand sales of our products to China, Korea, South America and the domestic Japanese market. We anticipate that Hong Kong and the domestic Japanese market will be the geographic drivers of our business in the near future. However, there are no assurances that we will gain significant market share in those competitive markets. In addition, many North American, European and Japanese OEMs are moving their manufacturing sites to Southeast Asia as a result of the cyclical nature of manufacturing capacity issues and cost of silicon integrated circuits, the continued decline of average selling prices of chipsets and other industry-wide factors. This trend may cause the mix of our OEM customers to change in the future, thereby further necessitating our need to penetrate new markets.

Furthermore, to sustain the future growth of our business, we need to introduce new products as sales of our older products taper off. In consideration of this, we introduced our new DECT product for the European market in 2004. Sale of DECT products represented approximately 16% of our total revenues for the first quarter of 2007. We anticipate that sales of DECT products to the European market will be a key driver of our business in the near future. However, there are no assurances that we will successfully penetrate the competitive European DECT market or that our DECT products will achieve general market deployment and acceptance.

Moreover, the penetration of new competitive markets and introduction of new products could require us to reduce the sale prices of our products or increase the cost per product and thus reduce our total gross profit in future periods.

***Our failure to compete effectively in the U.S. DECT market could have a material adverse effect on our business.***

The U.S. digital telephony market is currently our dominant market as our OEM customers have significant market share in this market. Although the current telephony technology for the U.S. market is based on 2.4GHz and 5.8GHz products, we believe there may be a potential shift in the U.S. market towards DECT products. In 2005, at the conclusion of negotiations between the DECT Forum and the Federal Communications Commission (FCC), the FCC authorized the use of the DECT frequency band in the U.S. This FCC decision allows companies and households to use the multifunctional DECT technology for various communication needs and may lead to the expansion of the U.S. DECT market (DECT 6.0). However, we can provide no assurance that our current OEM customers, with whom we have strong existing relationships, will gain significant market share in the DECT 6.0 market. Moreover we can provide no assurance that our DECT 6.0 chipsets will be acceptable to our OEM customers or that OEM customers to whom we sale DECT 6.0 chipsets will gain significant market share. If we are unable to develop and market DECT products to compete effectively in any emerging DECT 6.0 market against the introduction of new products by our competitors, our profits and results of operation may be materially adversely effected. In addition, if our OEM customers do not succeed in penetrating any emerging DECT 6.0 market or fail to incorporate our chipsets in new DECT products introduced by them for this market, our business also could suffer.

***We are dependent on a small number of OEM customers, and our business could be harmed by the loss of any of these customers or reductions in their purchasing volumes.***

We sell our products to a limited number of OEM customers through a network of distributors and OEM representatives. Moreover, many North American, European and Japanese OEMs are moving their manufacturing sites to Southeast Asia, as a result of the cyclical nature of manufacturing capacity issues and cost of silicon integrated circuits, the continued decline of average selling prices of chipsets and other industry-wide factors. In addition, OEMs located in Southeast Asia are growing and gaining competitive strength. As a result, the mix of our OEM customers may change in the future. This trend also may promote the consolidation of OEMs located in North America, Europe and Japan with OEMs located in Southeast Asia, which may reduce the number of our potential customers and reduce the volume of

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chipsets the combined OEM may purchase from us. However, as is common in our industry, we typically do not enter into long term contracts with our customers in which they commit to purchase products from us. The loss of any of our OEM customers may have a material adverse effect on our results of operations.

Also, with the shift of manufacturing facilities to Southeast Asia, the mix of potential OEM customers may change in the future. However, we may not succeed in attracting new customers as these potential customers may have pre-existing relationships with our current or potential competitors and any consolidation of the OEM industry will further reduce the number of potential customers. To attract new customers, we may be faced with intense price competition, which may affect our revenues and gross margins.

***There are several emerging market trends that may challenge our ability to continue to grow our business.***

We believe new technological developments in the home residential market may adversely affect our operating results. For example, the rapid deployment of new communication access methods, including mobile, wireless broadband, cable and other connectivity, as well as the projected lack of growth in products using fixed-line telephony would reduce our total revenues derived from, and unit sales of, cordless telephony products. Our ability to maintain our growth will depend on the expansion of our product lines to capitalize on the emerging access methods and on our success in developing and selling a portfolio of system-on-a-chip solutions that integrate video, voice, data and communication technologies in a wider multimedia market, as well as on our success in developing and selling DECT, CoIP and video products. We cannot assure you that we will succeed in expanding our product lines, or develop and sell in a timely manner a portfolio of system-on-a-chip solutions.

Furthermore, there is a growing threat from alternative technologies accelerating the decline of the fixed-line telephony market. This competition comes mainly from mobile telephony, including emerging dual-mode mobile Wi-Fi phones, but also from other innovative applications, such as Skype. Given that we derive a significant amount of revenues from chipsets incorporated into fixed-line telephony products, if we are unable to develop new technologies in the face of the decline of this market, our business could be materially adversely affected.

***The possible emerging trend of our OEM customers outsourcing their production may cause our revenue to decline.***

We believe there may be an emerging trend of our OEM customers outsourcing their production to third parties. We have invested substantial resources to build relationships with our OEM customers. However the outsourcing companies whom our OEM customers may choose to outsource production may not have prior business relationship with us or may instead have prior or ongoing relationships with our competitors. The emergence of this trend may require us to expend substantial additional resources to build relationships with these outsourcing companies, which would increase our operating expenses. Even if we do expend such resources, there are no assurances that these outsourcing companies will choose to incorporate our chipsets rather than chipsets of our competitors. Our inability to retain an OEM customer once such customer chooses to outsource production would have a material adverse effect on our future revenue.

***Because we have significant operations in Israel, we may be subject to political, economic and other conditions affecting Israel that could increase our operating expenses and disrupt our business.***

Our principal research and development facilities are located in the State of Israel and, as a result, at March 31, 2007, 250 of our 320 employees were located in Israel, including 157 out of 210 of our research and development personnel. In addition, although we are incorporated in Delaware, a majority of our directors and executive officers are residents of Israel. Although substantially all of our sales currently are being made to customers outside of Israel, we are nonetheless directly influenced by the political, economic and military conditions affecting Israel. Any major hostilities involving Israel, or the interruption or curtailment of trade between Israel and its present trading partners, could significantly harm our business, operating results and financial condition.

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Israel's economy has been subject to numerous destabilizing factors, including a period of rampant inflation in the early to mid-1980s, low foreign exchange reserves, fluctuations in world commodity prices, military conflicts and civil unrest. In addition, Israel and companies doing business with Israel have been the subject of an economic boycott by the Arab countries since Israel's establishment. Although they have not done so to date, these restrictive laws and policies may have an adverse impact on our operating results, financial condition or expansion of our business.

Since the establishment of the State of Israel in 1948, a state of hostility has existed, varying in degree and intensity, between Israel and the Arab countries. Although Israel has entered into various agreements with certain Arab countries and the Palestinian Authority, and various declarations have been signed in connection with efforts to resolve some of the economic and political problems in the Middle East, hostilities between Israel and some of its Arab neighbors have recently escalated and intensified. We cannot predict whether or in what manner these conflicts will be resolved. Our results of operations may be negatively affected by the obligation of key personnel to perform military service. In addition, certain of our officers and employees are currently obligated to perform annual reserve duty in the Israel Defense Forces and are subject to being called for active military duty at any time. Although we have operated effectively under these requirements since our inception, we cannot predict the effect of these obligations on the company in the future. Our operations could be disrupted by the absence, for a significant period, of one or more of our officers or key employees due to military service.

***The tax benefits available to us under Israeli law require us to meet several conditions, and may be terminated or reduced in the future, which would increase our taxes.***

Our facilities in Israel have been granted Approved Enterprise status under the Law for the Encouragement of Capital Investments, 1959, commonly referred to as the Investment Law. The Investment Law provides that capital investments in a production facility (or other eligible assets) may be designated as an Approved Enterprise. Under that law, we receive certain tax benefits in Israel. To be eligible for tax benefits, we must meet certain conditions, relating principally to adherence to the investment program filed with the Investment Center of the Israeli Ministry of Industry and Trade and to periodic reporting obligations. Although we believe we have met such conditions in the past, should we fail to meet such conditions in the future, we would be subject to corporate tax in Israel at the standard corporate tax rate (29% for 2007) and could be required to refund tax benefits already received. We cannot assure you that such grants and tax benefits will be continued in the future at their current levels, if at all. The tax benefits under these investment plans are scheduled to gradually expire by 2015. The termination or reduction of certain programs and tax benefits (particularly benefits available to us as a result of the Approved Enterprise status of our facilities and programs) or a requirement to refund tax benefits already received may have a material adverse effect on our business, operating results and financial condition. On April 1, 2005, an amendment to the Investment Law came into effect. The amendment revised the criteria for investments qualified to receive tax benefits. An eligible investment program under the amendment will qualify for benefits as a Privileged Enterprise (rather than the previous terminology of Approved Enterprise). Among other things, the amendment provides tax benefits to both local and foreign investors and simplifies the approval process. The amendment does not apply to investment programs approved prior to December 31, 2004. The new tax regime will apply to new investment programs only. We believe that we are currently in compliance with these requirements. However, if we fail to meet these requirements, we would be subject to corporate tax in Israel at the regular statutory rate (29% for 2007). We could also be required to refund tax benefits, with interest and adjustments for inflation based on the Israeli consumer price index.

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*We may engage in future acquisitions that could dilute our stockholders' equity and harm our business, results of operations and financial condition.*

We have pursued, and will continue to pursue, growth opportunities through internal development and acquisition of complementary businesses, products and technologies. We are unable to predict whether or when any other prospective acquisition will be completed. The process of integrating an acquired business may be prolonged due to unforeseen difficulties and may require a disproportionate amount of our resources and management's attention. We cannot assure you that we will be able to successfully identify suitable acquisition candidates, complete acquisitions, integrate acquired businesses into our operations, or expand into new markets. Further, once integrated, acquisitions may not achieve comparable levels of revenues, profitability or productivity as our existing business or otherwise perform as expected. The occurrence of any of these events could harm our business, financial condition or results of operations. Future acquisitions may require substantial capital resources, which may require us to seek additional debt or equity financing.

Future acquisitions by us could result in the following, any of which could seriously harm our results of operations or the price of our stock:

issuance of equity securities that would dilute our current stockholders' percentages of ownership;

large one-time write-offs;

the incurrence of debt and contingent liabilities;

difficulties in the assimilation and integration of operations, personnel, technologies, products and information systems of the acquired companies;

diversion of management's attention from other business concerns;

contractual disputes;

risks of entering geographic and business markets in which we have no or only limited prior experience; and

potential loss of key employees of acquired organizations.

*Third party claims of infringement or other claims against us could adversely affect our ability to market our products, require us to redesign our products or seek licenses from third parties, and seriously harm our operating results and disrupt our business.*

As is typical in the semiconductor industry, we have been and may from time to time be notified of claims that we may be infringing patents or intellectual property rights owned by third parties. For example, in a lawsuit against Microsoft Corporation, AT&T asserted that our TrueSpeech 8.5 algorithm includes certain elements covered by a patent held by AT&T. AT&T sued Microsoft, one of our TrueSpeech 8.5 licensees, for infringement. We were not named in AT&T's suit against Microsoft. If litigation becomes necessary to determine the validity of any third party claims, it could result in significant expense to us and could divert the efforts of our technical and management personnel, whether or not the litigation is determined in our favor.

If it appears necessary or desirable, we may try to obtain licenses for those patents or intellectual property rights that we are allegedly infringing. Although holders of these types of intellectual property rights commonly offer these licenses, we cannot assure you that licenses will be offered or that the terms of any offered licenses will be acceptable to us. Our failure to obtain a license for key intellectual property rights from a third party for technology used by us could cause us to incur substantial liabilities and to suspend the manufacturing of products utilizing the technology.



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Alternatively, we could be required to expend significant resources to develop non-infringing technology. We cannot assure you that we would be successful in developing non-infringing technology.

***We may not be able to adequately protect or enforce our intellectual property rights, which could harm our competitive position.***

Our success and ability to compete is in part dependent upon our internally-developed technology and other proprietary rights, which we protect through a combination of copyright, trademark and trade secret laws, as well as through confidentiality agreements and licensing arrangements with our customers, suppliers, employees and consultants. In addition, we have filed a number of patents in the United States and in other foreign countries with respect to new or improved technology that we have developed. However, the status of any patent involves complex legal and factual questions, and the breadth of claims allowed is uncertain. Accordingly, we cannot assure you that any patent application filed by us will result in a patent being issued, or that the patents issued to us will not be infringed by others. Also, our competitors and potential competitors may develop products with similar technology or functionality as our products, or they may attempt to copy or reverse engineer aspects of our product line or to obtain and use information that we regard as proprietary. Moreover, the laws of certain countries in which our products are or may be developed, manufactured or sold, including Hong Kong, Japan and Taiwan, may not protect our products and intellectual property rights to the same extent as the laws of the United States. Policing the unauthorized use of our products is difficult and may result in significant expense to us and could divert the efforts of our technical and management personnel. Even if we spend significant resources and efforts to protect our intellectual property, we cannot assure you that we will be able to prevent misappropriation of our technology. Use by others of our proprietary rights could materially harm our business and expensive litigation may be necessary in the future to enforce our intellectual property rights.

***Because our products are complex, the detection of errors in our products may be delayed, and if we deliver products with defects, our credibility will be harmed, the sales and market acceptance of our products may decrease and product liability claims may be made against us.***

Our products are complex and may contain errors, defects and bugs when introduced. If we deliver products with errors, defects or bugs, our credibility and the market acceptance and sales of our products could be significantly harmed. Furthermore, the nature of our products may also delay the detection of any such error or defect. If our products contain errors, defects and bugs, then we may be required to expend significant capital and resources to alleviate these problems. This could result in the diversion of technical and other resources from our other development efforts. Any actual or perceived problems or delays may also adversely affect our ability to attract or retain customers. Furthermore, the existence of any defects, errors or failures in our products could lead to product liability claims or lawsuits against us or against our customers. We generally provide our customers with a standard warranty for our products, generally lasting one year from the date of purchase. Although we attempt to limit our liability for product defects to product replacements, we may not be successful, and customers may sue us or claim liability for the defective products. A successful product liability claim could result in substantial cost and divert management's attention and resources, which would have a negative impact on our financial condition and results of operations.

***We are exposed to the credit risk of our customers and to credit exposures in weakened markets, which could result in material losses.***

Most of our sales are on an open credit basis. We expect demand for enhanced open credit terms, for example, longer payment terms, to continue and believe that such arrangements are a competitive factor in obtaining business. Although we monitor and attempt to mitigate credit risks, including through insurance coverage from time to time, there can be no assurance that our efforts will be effective. Moreover, even if we attempt to mitigate credit risks through insurance coverage, such coverage may not be sufficient to cover all of our losses and we would be subject to a deductible

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under any insurance coverage. Although any losses to date relating to credit exposure of our customers have not been material, future losses, if incurred, could harm our business and have a material adverse effect on our operating results and financial condition.

***Our executive officers and key personnel are critical to our business, and because there is significant competition for personnel in our industry, we may not be able to attract and retain such qualified personnel.***

Our success depends to a significant degree upon the continued contributions of our executive management team, and our technical, marketing, sales customer support and product development personnel. The loss of significant numbers of such personnel could significantly harm our business, financial condition and results of operations. We do not have any life insurance or other insurance covering the loss of any of our key employees. Because our products are specialized and complex, our success depends upon our ability to attract, train and retain qualified personnel, including qualified technical, marketing and sales personnel. However, the competition for personnel is intense and we may have difficulty attracting and retaining such personnel.

***We are exposed to fluctuations in currency exchange rates.***

A significant portion of our business is conducted outside the United States. Export sales to manufacturers in Europe and Asia, including Japan and Asia Pacific, represented 100% of our total revenues for the first quarter of 2007. Although most of our revenue and expenses are transacted in U.S. dollars, we may be exposed to currency exchange fluctuations in the future as business practices evolve and we are forced to transact business in local currencies. Moreover, part of our expenses in Israel are paid in Israeli currency, which subjects us to the risks of foreign currency fluctuations between the U.S. dollar and the New Israeli Shekel (NIS) and to economic pressures resulting from Israel's general rate of inflation. Our primary expenses paid in NIS are employee salaries and lease payments on our Israeli facilities. As a result, an increase in the value of Israeli currency in comparison to the U.S. dollar could increase the cost of our technology development, research and development expenses and general and administrative expenses. From time to time, we use derivative instruments in order to minimize the effects of currency fluctuations, but our hedging positions may be partial, may not exist at all in the future or may not succeed in minimizing our foreign currency fluctuation risks.

***Because the markets in which we compete are subject to rapid changes, our products may become obsolete or unmarketable.***

The markets for our products and services are characterized by rapidly changing technology, short product life cycles, evolving industry standards, changes in customer needs, demand for higher levels of integration, growing competition and new product introductions. Our future growth is dependent not only on the continued success of our existing products but also successful introduction of new products as some of our existing products, such as 900MHz and 2.4GHz, experienced decreased sales. Our ability to adapt to changing technology and anticipate future standards, and the rate of adoption and acceptance of those standards, will be a significant factor in maintaining or improving our competitive position and prospects for growth. If new industry standards emerge, our products or our customers' products could become unmarketable or obsolete, and we could lose market share. We may also have to incur substantial unanticipated costs to comply with these new standards. If our product development and improvements take longer than planned, the availability of our products would be delayed. Any such delay may render our products obsolete or unmarketable, which would have a negative impact on our ability to sell our products and our results of operations.

Because of changing customer requirements and emerging industry standards, we may not be able to achieve broad market acceptance of our products. Our success is dependent, in part, on our ability to:

successfully develop, introduce and market new and enhanced products at competitive prices and in a timely manner in order to meet changing customer needs;

convince leading OEMs to select our new and enhanced products for design into their own new products;



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respond effectively to new technological changes or new product announcements by others;

effectively use and offer leading technologies; and

maintain close working relationships with our key customers.

We cannot be sure that we will be successful in these pursuits, that the growth in demand will continue or that our products will achieve market acceptance. Our failure to develop and introduce new products that are compatible with industry standards and that satisfy customer requirements, and the failure of our products to achieve broad market acceptance, could have a negative impact on our ability to sell our products and our results of operations.

***Because the markets in which we compete are highly competitive, and many of our competitors have greater resources than we do, we cannot be certain that our products will be accepted in the marketplace or capture market share.***

The markets in which we operate are extremely competitive and characterized by rapid technological change, evolving standards, short product life cycles and price erosion. We expect competition to intensify as current competitors expand their product offerings and new competitors enter the market. Given the highly competitive environment in which we operate, we cannot be sure that any competitive advantages enjoyed by our current products would be sufficient to establish and sustain our new products in the market. Any increase in price or competition could result in the erosion of our market share, to the extent we have obtained market share, and would have a negative impact on our financial condition and results of operations.

In each of our business activities, we face current and potential competition from competitors that have significantly greater financial, technical, manufacturing, marketing, sales and distribution resources and management expertise than we do. These competitors may also have pre-existing relationships with our customers or potential customers. Further, in the event of a manufacturing capacity shortage, these competitors may be able to manufacture products when we are unable to do so. Our principal competitors in the cordless market include SiTel (formerly the DECT division of National Semiconductor), NXP, Oki Electronic, Micro Linear and Infineon. Our principal competitors in the VoIP market include Broadcom, AudioCodes, Texas Instruments, Infineon and new Taiwanese IC vendors.

As discussed above, various new developments in the home residential market may require us to enter into new markets with competitors that have more established presence, and significantly greater financial, technical, manufacturing, marketing, sales and distribution resources and management expertise than we do. The expenditure of greater resources to expand our current product lines and develop a portfolio of system-on-a-chip solutions that integrate video, voice, data and communication technologies in a wider multimedia market may increase our operating expenses and reduce our gross profit. We cannot assure you that we will succeed in developing and introducing new products that are responsive to market demands.

***An unfavorable government review of our federal income tax returns or changes in our effective tax rates could adversely affect our operating results.***

Our future effective tax rates could be adversely affected by earnings being lower than anticipated in countries where we have lower statutory rates and higher than anticipated in countries where we have higher statutory rates, by changes in the valuation of our deferred tax assets and liabilities, or by changes in tax laws, regulations, accounting principles or interpretations thereof.

In addition, we are subject to the periodic examination of our income tax returns by the IRS and other tax authorities. We regularly assess the likelihood of adverse outcomes resulting from these examinations to determine the adequacy of our provision for income taxes. The outcomes from these examinations may have an adverse effect on our operating results and financial condition. Our U.S. Federal income tax returns for 2003 and 2004 have been selected for audit by the Internal Revenue Service. While we believe that we have made adequate provisions related to the audits of

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these tax returns, the final determination of our obligations may exceed the amounts provided for by us in the accompanying Consolidated Financial Statements. Specifically, we may receive assessments related to the audits and/or reviews of our U.S. income tax returns that exceed amounts provided for by us. In the event we are unsuccessful in reducing the amount of such assessments, our business, financial condition or results of operations could be adversely affected. Further, if additional taxes and/or penalties are assessed as a result of these audits, there could be a material effect on our income tax provision, operating expenses and net income in the period or periods for which that determination is made.

***We may experience difficulties in transitioning to smaller geometry process technologies or in achieving higher levels of design integration, which may result in reduced manufacturing yields, delays in product deliveries and increased expenses.***

A growing trend in our industry is the integration of greater semiconductor content into a single chip to achieve higher levels of functionality. In order to remain competitive, we must achieve higher levels of design integration and deliver new integrated products on a timely basis. This will require us to expend greater research and development resources, and may require us to modify the manufacturing processes for some of our products, to achieve greater integration. We periodically evaluate the benefits, on a product-by-product basis, of migrating to smaller geometry process technologies to reduce our costs. Although this migration to smaller geometry process technologies has helped us to offset the declining average selling prices of our IDT products, this effort may not continue to be successful. Also, because we are a fabless semiconductor company, we depend on our foundries to transition to smaller geometry processes successfully. We cannot assure you that our foundries will be able to effectively manage the transition. In case our foundries or we experience significant delays in this transition or fail to efficiently implement this transition, our business, financial condition and results of operations could be materially and adversely affected.

***Our certificate of incorporation and bylaws contain anti-takeover provisions that could prevent or discourage a third party from acquiring us.***

Our certificate of incorporation and bylaws contain provisions that may prevent or discourage a third party from acquiring us, even if the acquisition would be beneficial to our stockholders. We have a staggered board, which means it will generally take two years to change the composition of our board. Our board of directors also has the authority to fix the rights and preferences of shares of our preferred stock and to issue such shares without a stockholder vote. We also have a rights plan in place. It is possible that these provisions may prevent or discourage third parties from acquiring us, even if the acquisition would be beneficial to our stockholders. In addition, these factors may also adversely affect the market price of our common stock, and the voting and other rights of the holders of our common stock.

***Our stock price may be volatile so you may not be able to resell your shares of our common stock at or above the price you paid for them.***

Announcements of developments related to our business, announcements by competitors, quarterly fluctuations in our financial results, changes in the general conditions of the highly dynamic industry in which we compete or the national economies in which we do business, and other factors could cause the price of our common stock to fluctuate, perhaps substantially. In addition, in recent years, the stock market has experienced extreme price fluctuations, which have often been unrelated to the operating performance of affected companies. These factors and fluctuations could have a material adverse effect on the market price of our common stock.

## **ITEM 6. EXHIBITS.**

Exhibit 31.1 Certification of the Chief Executive Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.

Exhibit 31.2 Certification of the Chief Financial Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.

Exhibit 32.1 Certification of the Chief Executive Officer Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

Exhibit 32.2 Certification of the Chief Financial Officer Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

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**SIGNATURES**

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

DSP GROUP, INC.  
(Registrant)

Date: May 8, 2007

By: /s/ Dror Levy  
Dror Levy, Vice President of Finance, Chief Financial Officer and  
Secretary  
(Principal Financial Officer and Principal Accounting Officer)

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