

AT HOME IN YOUR WIRELESS WORLD



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REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To The Stockholders of

DSP GROUP, INC. AND ITS SUBSIDIARIES

We have audited the accompanying consolidated balance sheets of DSP Group, Inc. ("the Company") and its subsidiaries as of December 31, 2006 and 2005, and the related consolidated statements of income, changes in stockholders' equity and cash flows for each of the three years in the period ended December 31, 2006. Our audits also included the financial statement schedule listed in the Index at Item 15(a). These financial statements and schedule are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements and schedule based on our audits.

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

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the consolidated financial position of the Company and its subsidiaries as of December 31, 2006 and 2005, and the consolidated results of their operations and their cash flows for each of the three years in the period ended December 31, 2006, in conformity with U.S. generally accepted accounting principles. Also, in our opinion, the related financial statement schedule, when considered in relation to the basic financial statements taken as a whole, presents fairly in all material respects the information set forth therein.

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

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the effectiveness of DSP Group, Inc.'s internal control over financial reporting as of December 31, 2006, based on criteria established in Internal Control-Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission and our report dated March 14, 2007 expressed, an unqualified opinion thereon.

KOST FORER GABBAY & KASIERER

A Member of Ernst & Young Global

Tel-Aviv, Israel

March 14, 2007

DSP GROUP INC. AND ITS SUBSIDIARIES

CONSOLIDATED BALANCE SHEETS

U.S. dollars in thousands

| | December 31, | |
|--|---------------------|-------------------|
| | 2006 | 2005 |
| ASSETS | | |
| CURRENT ASSETS: | | |
| Cash and cash equivalents | \$ 37,344 | \$ 50,460 |
| Short-term investment | 22,698 | 37,053 |
| Held-to-maturity marketable securities | 109,472 | 71,875 |
| Trade receivables, net | 21,489 | 16,991 |
| Deferred income taxes | 1,516 | 1,227 |
| Other accounts receivable and prepaid expenses | 4,049 | 1,617 |
| Inventories | 14,366 | 12,686 |
| TOTAL CURRENT ASSETS | 210,934 | 191,909 |
| PROPERTY AND EQUIPMENT, NET | 12,644 | 11,704 |
| LONG-TERM ASSETS: | | |
| Long-term held-to-maturity marketable securities | 179,368 | 185,828 |
| Long-term prepaid expenses and lease deposits | 672 | 670 |
| Deferred income taxes | 1,987 | 1,638 |
| Severance pay fund | 5,689 | 4,419 |
| Intangible assets, net | 1,194 | 2,337 |
| Goodwill | 1,500 | 1,500 |
| | 190,410 | 196,392 |
| TOTAL ASSETS | \$ 413,988 | \$ 400,005 |

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

DSP GROUP INC. AND ITS SUBSIDIARIES

CONSOLIDATED BALANCE SHEETS

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

| | <u>December 31,</u> | |
|---|---------------------|-------------------|
| | <u>2006</u> | <u>2005</u> |
| LIABILITIES AND STOCKHOLDERS' EQUITY | | |
| CURRENT LIABILITIES: | | |
| Trade payables | \$ 12,205 | \$ 12,753 |
| Accrued compensation and benefits | 9,215 | 10,736 |
| Income taxes payables | 10,359 | 11,511 |
| Accrued expenses and other accounts payable | 9,395 | 11,164 |
| TOTAL CURRENT LIABILITIES | <u>41,174</u> | <u>46,164</u> |
| ACCRUED SEVERANCE PAY | <u>6,065</u> | <u>4,707</u> |
| STOCKHOLDERS' EQUITY: | | |
| Preferred stock, \$0.001 par value—Authorized shares: 5,000,000 at December 31, 2006 and 2005; Issued and outstanding shares: none at December 31, 2006 and 2005 | — | — |
| Common stock, \$0.001 par value—Authorized shares: 50,000,000 at December 31, 2006 and 2005; Issued and outstanding: 28,377,838 and 28,596,340 shares at December 31, 2006 and 2005, respectively | 28 | 29 |
| Additional paid-in capital | 216,041 | 188,539 |
| Treasury stock | (44,546) | (19,447) |
| Accumulated other comprehensive income | 28 | 45 |
| Retained earnings | 195,198 | 179,968 |
| TOTAL STOCKHOLDERS' EQUITY | <u>366,749</u> | <u>349,134</u> |
| TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY | <u>\$ 413,988</u> | <u>\$ 400,005</u> |

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

DSP GROUP INC. AND ITS SUBSIDIARIES
CONSOLIDATED STATEMENTS OF INCOME

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

| | Year ended December 31, | | |
|--|-------------------------|------------------|------------------|
| | 2006 | 2005 | 2004 |
| Revenues | \$ 216,948 | \$ 187,225 | \$ 157,511 |
| Costs of revenues(1) | 128,559 | 101,074 | 80,368 |
| Gross profit | 88,389 | 86,151 | 77,143 |
| Operating expenses: | | | |
| Research and development(2) | 47,525 | 40,290 | 32,147 |
| Sales and marketing(3) | 16,306 | 13,119 | 11,292 |
| General and administrative(4) | 11,137 | 7,398 | 7,112 |
| Impairment of goodwill | — | — | 4,304 |
| In-process research and development write-off | — | — | 2,682 |
| Total operating expenses | 74,968 | 60,807 | 57,537 |
| Operating income | 13,421 | 25,344 | 19,606 |
| Financial and other income: | | | |
| Interest and other, net | 13,198 | 10,166 | 8,522 |
| Capital gains from available-for-sale marketable securities | — | — | 44,448 |
| Income before taxes on income | 26,619 | 35,510 | 72,576 |
| Taxes on income(5) | 4,240 | 6,037 | 21,482 |
| Net income | <u>\$ 22,379</u> | <u>\$ 29,473</u> | <u>\$ 51,094</u> |
| Net earnings per share: | | | |
| Basic | <u>\$ 0.76</u> | <u>\$ 1.04</u> | <u>\$ 1.79</u> |
| Diluted | <u>\$ 0.74</u> | <u>\$ 0.99</u> | <u>\$ 1.70</u> |
| Weighted average number of shares used in per share computations of: | | | |
| Basic | 29,343 | 28,435 | 27,959 |
| Diluted | <u>30,049</u> | <u>29,843</u> | <u>29,092</u> |

- (1) Includes equity-based compensation expense in the amount of \$461, \$0, \$0, for the year ended December 31, 2006, 2005 and 2004, respectively.
- (2) Includes equity-based compensation expense in the amount of \$6,353, \$0, \$0, for the year ended December 31, 2006, 2005 and 2004, respectively.
- (3) Includes equity-based compensation expense in the amount of \$1,319, \$0, \$0, for the year ended December 31, 2006, 2005 and 2004, respectively.
- (4) Includes equity-based compensation expense in the amount of \$3,990, \$0, \$0, for the year ended December 31, 2006, 2005 and 2004, respectively.
- (5) Includes tax benefit resulting from equity-based compensation expense in the amount of \$490, \$0, \$0 for the year ended December 31, 2006, 2005 and 2004, respectively.

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

DSP GROUP INC. AND ITS SUBSIDIARIES
STATEMENTS OF CHANGES IN STOCKHOLDERS' EQUITY

U.S. dollars and shares in thousands

| | Number of shares of Common stock | Common stock amount | Additional paid-in capital | Treasury stock | Accumulated other comprehensive income | Retained earnings | Total comprehensive income | Total stockholders' equity |
|--|---|---------------------------|----------------------------------|-------------------|---|----------------------|----------------------------------|----------------------------------|
| Balance at January 1, 2004 | 28,616 | \$ 29 | \$ 174,700 | \$ (1,192) | \$ 23,045 | \$ 107,799 | | \$ 304,381 |
| Issuance of treasury stock upon purchase of ESPP shares by employees | 31 | *)— | — | 732 | — | (326) | | 406 |
| Issuance of common stock upon exercise of stock options by employees | 732 | *)— | 11,659 | — | — | — | | 11,659 |
| Issuance of common stock upon purchase of ESPP shares by employees | 38 | *)— | 547 | — | — | — | | 547 |
| Issuance of treasury stock upon exercise of stock options by employees | 114 | *)— | — | 2,359 | — | (844) | | 1,515 |
| Tax benefit related to exercise of stock options | — | — | 565 | — | — | — | | 565 |
| Purchase of treasury stock | (1,577) | (1) | — | (31,696) | — | — | | (31,697) |
| Total comprehensive income: | | | | | | | | |
| Net income | — | — | — | — | — | 51,094 | \$ 51,094 | 51,094 |
| Realized gains on available-for-sale marketable securities | — | — | — | — | (22,908) | — | (22,908) | (22,908) |
| Unrealized loss from hedging activities, net | — | — | — | — | (72) | — | (72) | (72) |
| Total comprehensive income | | | | | | | <u>\$ 28,114</u> | |
| Balance at December 31, 2004 | 27,954 | 28 | 187,471 | (29,797) | 65 | 157,723 | | 315,490 |
| Issuance of treasury stock upon purchase of ESPP shares by employees | 74 | *)— | — | 1,493 | — | (110) | | 1,383 |
| Issuance of treasury stock upon exercise of stock options by employees | 1,250 | 1 | 223 | 25,895 | — | (7,118) | | 19,001 |
| Tax benefit related to exercise of stock options | — | — | 845 | — | — | — | | 845 |
| Purchase of treasury stock | (682) | *)— | — | (17,038) | — | — | | (17,038) |
| Total comprehensive income: | | | | | | | | |
| Net income | — | — | — | — | — | 29,473 | \$ 29,473 | 29,473 |
| Unrealized loss from hedging activities, net | — | — | — | — | (20) | — | (20) | (20) |
| Total comprehensive income | | | | | | | <u>\$ 29,453</u> | |

*) Represents an amount lower than \$1.

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

DSP GROUP INC. AND ITS SUBSIDIARIES
STATEMENTS OF CHANGES IN STOCKHOLDERS' EQUITY

U.S. dollars and shares in thousands

| | Number of shares of Common stock | Common stock amount | Additional paid-in capital | Treasury stock | Accumulated other comprehensive income | Retained earnings | Total comprehensive income | Total stockholders' equity |
|--|---|---------------------------|----------------------------------|--------------------|---|----------------------|----------------------------------|----------------------------------|
| Balance at December 31, 2005 | 28,596 | 29 | 188,539 | (19,447) | 45 | 179,968 | | 349,134 |
| Issuance of treasury stock upon purchase of ESPP shares by employees | 80 | *)— | — | 1,939 | — | (438) | | 1,501 |
| Issuance of common stock upon exercise of stock options by employees | 852 | 1 | 14,499 | — | | | | 14,500 |
| Issuance of treasury stock upon exercise of stock options by employees | 1,092 | *)— | 203 | 25,810 | — | (6,711) | | 19,302 |
| Tax benefit related to exercise of stock options | — | — | 675 | — | — | — | | 675 |
| Purchase of treasury stock | (2,242) | (2) | 2 | (52,848) | — | — | | (52,848) |
| Equity-based compensation expenses resulting from FAS 123(R) | — | — | 12,123 | — | — | — | — | 12,123 |
| Total comprehensive income: | — | — | | | | | | |
| Net income | — | — | — | — | — | 22,379 | \$ 22,379 | 22,379 |
| Unrealized loss from hedging activities, net | — | — | — | — | (17) | — | (17) | (17) |
| Total comprehensive income | — | — | | | (17) | | \$ 22,362 | |
| Balance at December 31, 2006 | <u>28,378</u> | <u>\$ 28</u> | <u>\$ 216,041</u> | <u>\$ (44,546)</u> | <u>\$ 28</u> | <u>\$ 195,198</u> | | <u>\$ 366,749</u> |

*) Represents an amount lower than \$1.

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

DSP GROUP INC. AND ITS SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CASH FLOWS

U.S. dollars in thousands

| | Year ended December 31, | | |
|---|-------------------------|-----------------|---------------|
| | 2006 | 2005 | 2004 |
| Cash flows from operating activities: | | | |
| Net income | \$ 22,379 | \$ 29,473 | \$ 51,094 |
| Adjustments required to reconcile net income to net cash provided by operating activities: | | | |
| Depreciation | 6,001 | 4,599 | 2,506 |
| Stock-based compensation expenses related to employees' stock options | 12,123 | — | — |
| Increase in deferred income taxes, net | (639) | (287) | (1,252) |
| Capital gain from available-for-sale marketable securities of traded companies | — | — | (44,448) |
| Amortization of intangible assets | 1,143 | 1,145 | 718 |
| Impairment of goodwill | — | — | 4,304 |
| In-process research and development write-off | — | — | 2,682 |
| Accrued interest and amortization of premium on held-to-maturity marketable securities and short-term investments | 1,105 | 2,437 | 2,321 |
| Tax benefit related to exercise of stock options | — | 845 | 565 |
| Decrease (increase) in trade receivables | (4,498) | (11,015) | 9,868 |
| Decrease (increase) in other accounts receivable and prepaid expenses | (2,291) | 509 | (826) |
| Increase in inventories | (1,680) | (3,217) | (1,003) |
| Increase in long-term prepaid expenses and lease deposits | (2) | (42) | (115) |
| Increase (decrease) in trade payables | (548) | 4,990 | (3,391) |
| Increase (decrease) in accrued compensation and benefits | (19) | 2,095 | 421 |
| Increase (decrease) in income taxes payable | (1,120) | (5,572) | 4,608 |
| Decrease in accrued expenses and other accounts payable | (1,768) | (739) | (832) |
| Increase (decrease) in accrued severance pay, net | 88 | (59) | 152 |
| Other | — | — | 21 |
| Net cash provided by operating activities | 30,274 | 25,162 | 27,393 |
| Cash flows from investing activities: | | | |
| Purchase of held-to-maturity marketable securities and short-term investments | (108,885) | (105,142) | (141,173) |
| Proceeds from maturity of held-to-maturity marketable securities and short-term investments | 91,080 | 78,117 | 108,246 |
| Purchase of property and equipment | (6,941) | (9,620) | (1,759) |
| Proceeds from realization of available-for-sale equity securities of traded companies | — | — | 55,456 |
| Payment for acquisition of Bermai Inc. assets | — | — | (5,128) |
| Payment for acquisition of Teleman Multimedia Inc. assets | — | (1,450) | (1,450) |
| Net cash provided by (used in) investing activities | (24,746) | (38,095) | 14,192 |

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

DSP GROUP INC. AND ITS SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CASH FLOWS

U.S. dollars in thousands

| | Year ended December 31, | | |
|--|-------------------------|------------------|------------------|
| | 2006 | 2005 | 2004 |
| Cash flows from financing activities: | | | |
| Issuance of common stock and treasury stock upon exercise of stock options | 33,561 | 19,604 | 14,127 |
| Purchase of treasury stock | (52,848) | (17,038) | (31,697) |
| Tax benefit related to exercise of stock options | 643 | — | — |
| Net cash provided by (used in) financing activities | <u>(18,644)</u> | <u>2,566</u> | <u>(17,570)</u> |
| Increase (decrease) in cash and cash equivalents | (13,116) | (10,367) | 24,015 |
| Cash and cash equivalents at the beginning of the year | 50,460 | 60,827 | 36,812 |
| Cash and cash equivalents at the end of the year | <u>\$ 37,344</u> | <u>\$ 50,460</u> | <u>\$ 60,827</u> |
| Supplemental disclosures of cash flows activities: | | | |
| Cash paid during the year for: | | | |
| Taxes on income | <u>\$ 7,286</u> | <u>\$ 10,948</u> | <u>\$ 17,149</u> |

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

DSP GROUP INC. AND ITS SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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

NOTE 1:- GENERAL

DSP Group Inc. (the "Company"), a Delaware corporation, and its subsidiaries are fabless semiconductor companies operating in the short-range residential wireless communications market. By combining its proprietary technologies and advanced design methodologies, the Company offers original equipment manufacturers (OEMs) and original design manufacturers (ODMs) complex Integrated Circuit (IC) solutions. The Company's system-on-a-chip solution includes applications for digital 900MHz, 2.4GHz and 5.8GHz telephony, European Digital Enhanced Cordless Telecommunications (DECT) telephony, and Bluetooth systems for voice, data and video communication in residential and SOHO/SME (small-office home-office and small to medium enterprise) environments. In addition, the Company offers IC products that are used in hand-held Digital Voice Recorders, MP3 players, Voice over Internet Protocols (VoIP) phones, residential gateways, and Integrated Access Devices (IADs).

The Company has six wholly-owned subsidiaries: (1) DSP Group Ltd. ("DSP Group Israel"), an Israeli corporation primarily engaged in research and development, marketing and sales, technical support and certain general and administrative functions; (2) RF Integrated Systems Inc. ("RF US"), a Delaware corporation primarily engaged in research and development of RF technology for wireless products; (3) Nihon DSP K.K. ("DSP Japan"), a Japanese corporation primarily engaged in marketing and technical support activities; (4) DSP Video Korea ("DSP Korea"), a Korean corporation, incorporated in 2003 and primarily engaged in the design, research and development of video applications; (5) DSPG Edinburgh Limited ("DSP Scotland"), a Scottish corporation, primarily engaged in development and marketing of DECT-based telephony solutions and (6) DSP R&D Ireland, an Irish corporation primarily engaged in development of a DECT-based telephony solutions.

All of the Company's integrated circuit products are manufactured and tested by independent foundries and test houses. While these foundries and test houses have been able to adequately meet the demands of the Company's increasing business, the Company is and will continue to be dependent upon these foundries and test houses to achieve acceptable manufacturing yields, quality levels and costs, and to allocate to the Company a sufficient portion of foundry and test capacity to meet the Company's needs in a timely manner. Revenues could be materially and adversely affected should any of these foundries and test houses fail to meet the Company's request for products due to a shortage of production capacity, process difficulties, low yield rates or financial instability. For example, foundries in Taiwan produce a significant portion of the Company's wafer supply. As a result, earthquakes, aftershocks or other natural disasters in Asia, could preclude the Company from obtaining an adequate supply of wafers to fill customers' orders and could harm the Company's business, financial position, and results of operations. Additionally, certain of the raw materials, components, and subassemblies included in the products manufactured by the Company's original equipment manufacturer (OEM) customers, which also incorporate the Company's products, are obtained from a limited group of suppliers. Disruptions, shortages, or termination of certain of these sources of supply could occur and could negatively affect the Company's business condition and results of operations.

The Company sells its products to customers primarily through a network of distributors and representatives. The Company's largest distributor, Tomen Electronics Corporation ("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 Tomen Electronics' sales. The Company's future performance will depend, in part, on Tomen Electronics' continued success in marketing and selling its products. The loss of Tomen Electronics as the Company's distributor and the Company's inability to obtain a satisfactory replacement in a timely manner may harm the Company's sales and results of operations. Additionally, the loss of Panasonic and Tomen Electronics' inability to thereafter effectively market the Company's products could also harm the Company's sales and results of operations.

DSP GROUP INC. AND ITS SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

Acquisition of Bermai Inc. assets

On October 15, 2004, the Company entered into an asset purchase agreement pursuant to the terms of which the Company acquired substantially all of the assets of Bermai Inc., a U.S. corporation (“Bermai”), for a total consideration of \$5,128 including transaction costs. The acquisition was made through a liquidator. Bermai developed an advanced Wi-Fi technology based on the 802.11 protocol that is optimized for quality of service for video streaming applications.

Based upon an independent valuation of tangible and intangible assets acquired, the Company allocated \$2,682 of the total consideration for the acquisition of Bermai’s assets to in process research and development, \$2,124 to patents and \$322 to tangible assets.

The value assigned to the patents acquired in the Bermai acquisition is amortized over a period of four years. The amount amortized during 2006, 2005 and 2004, was \$531, \$531 and \$103, respectively.

VoicePump Inc.

VoicePump, Inc. (“VoicePump”) was a wholly-owned subsidiary of the Company and a U.S. corporation primarily engaged in the design, research and development and marketing of software applications for Voice over Digital Subscriber Line (VoDSL) and Voice over Internet Protocol (VoIP). VoicePump, as a legal entity, was dissolved in January 2005, and its assets were transferred to the Company and DSP Group Israel.

The Company’s investment in VoicePump includes the excess of its purchase price over the net assets acquired which was attributed to goodwill.

During the second quarter of 2004, the Company decided to stop developing products targeted at the VoIP gateway market and to focus its efforts on VoIP telephony products. As a result of this decision, the Company assessed the carrying value of goodwill associated with VoicePump in accordance with Statement of Financial Accounting Standard No. 142 “Goodwill and Other Intangible Assets” (“SFAS No. 142”). The first step of the goodwill impairment test involved the determination of the fair value of VoicePump using the income approach based on the discounted cash flow model. This evaluation indicated that the carrying amount of VoicePump exceeded its fair value. In accordance with SFAS No. 142, if the carrying amount of a reporting unit exceeds its fair value, the second step of the goodwill impairment test is to measure the amount of the impairment loss. During the second step of the evaluation, the Company allocated the fair value of VoicePump to all of its assets and liabilities (including unrecognized intangible assets) as if VoicePump had been acquired in a business combination. The excess of the fair value of VoicePump over the amounts assigned to its assets and liabilities is the implied fair value of goodwill was estimated to be approximately \$1,500. As a result, the Company recorded a charge associated with the impairment of goodwill of VoicePump in the amount of \$4,304 in the second quarter of 2004. The expense was included in the Company’s operating expenses for the year ended December 31, 2004, under “Impairment of goodwill.” For a discussion about the impairment test done in 2006, see Note 2.

Use of estimates

The preparation of the financial statements in conformity with U.S. GAAP requires management to make estimates and assumptions that affect the amounts reported in the financial statements and accompanying notes. Actual results could differ from these estimates.

DSP GROUP INC. AND ITS SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES

Financial statements in U.S. dollars

All of the revenues of the Company and its subsidiaries are generated in U.S. dollars (“dollar”). In addition, a substantial portion of the costs of the Company and its subsidiaries are incurred in dollars. The Company’s management believes that the dollar is the currency of the primary economic environment in which the Company and its subsidiaries operate. Thus, the functional and reporting currency of the Company and its subsidiaries is the dollar.

Monetary accounts maintained in currencies other than the dollar are remeasured into dollars in accordance with Statement of Financial Accounting Standard No. 52, “Foreign Currency Translations.” All transaction gains and losses resulting from the remeasurement of monetary balance sheet items are reflected in the consolidated statements of income as financial income or expenses as appropriate, and have not been significant to date for all years presented.

Principles of consolidation

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

Cash and cash equivalents

The Company and its subsidiaries consider all highly liquid investments, which are readily convertible to cash with a maturity of three months or less at the date of acquisition, to be cash equivalents.

Short-term investments

The Company categorizes auction rate securities as available-for-sale short-term investments in accordance with Statement of Financial Accounting Standard No. 115, “Accounting for Certain Investments in Debt and Equity Securities” (“SFAS No. 115”). Auction rate securities are reported at cost, which approximates fair market value due to the interest rate reset feature of these securities. As such, no unrealized gains or losses related to these securities were recognized during the years ended December 31, 2006, 2005 and 2004.

The short-term investments also include bank deposits with original maturities of more than three months and less than one year which are presented at cost, including accrued interest.

Marketable securities

The Company and its subsidiaries account for investments in debt and equity securities in accordance with Statement of Financial Accounting Standard No. 115. Management determines the appropriate classification of the Company’s investments in debt and equity securities at the time of purchase and reevaluates such determinations at each balance sheet date.

At December 31, 2006 and 2005, the Company classified its investment in marketable securities as held-to-maturity.

Debt securities are classified as held-to-maturity, when the Company has the positive intent and ability to hold the securities to maturity, and are stated at amortized cost. The cost of held-to-maturity securities is adjusted for amortization of premiums and accretion of discounts to maturity. Such amortization, accretion and interest are included in financial income, net.

DSP GROUP INC. AND ITS SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

FASB Staff Position (FSP) No. 115-1, “The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investment” (“FSP 115-1”) provides guidance for determining when an investment is considered impaired, whether impairment is other-than-temporary, and measurement of an impairment loss. An investment is considered impaired if the fair value of the investment is less than its cost. If, after consideration of all available evidence to evaluate the realizable value of its investment, impairment is determined to be other-than-temporary, then an impairment loss should be recognized equal to the difference between the investment’s cost and its fair value. FSP 115-1 nullifies certain provisions of Emerging Issues Task Force (EITF) Issue No. 03-1, “The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments,” (“EITF 03-1”) while retaining the disclosure requirements of EITF 03-1 which the Company adopted in 2003. The adoption of FSP 115-1 by the Company on January 1, 2006 did not impact its financial position or results of operations.

Fair value of financial instruments

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

1. The carrying values of cash and cash equivalents, trade receivables and trade payables approximate fair values due to the short-term maturities of these instruments.
2. The carrying value of held-to-maturity marketable securities is based on amortized cost. The fair value of held-to-maturity securities is based on the quoted market price (see Note 3).
3. The fair value of derivative instruments is estimated by obtaining quotes from brokers.

Inventories

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

The Company and its subsidiaries periodically evaluate the quantities on hand relative to current and historical selling prices and historical and projected sales volume. Based on this evaluation, provisions are recorded when required to write-off inventory according to its market value.

Cost is determined as follows:

Work in progress—on the basis of raw material and manufacturing costs on an average basis.

Finished products—on the basis of raw material and manufacturing costs on an average basis.

Property and equipment

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

| | <u>%</u> |
|--------------------------------|--|
| Computers and equipment | 20-33 |
| Office furniture and equipment | 7-10 |
| Motor vehicles | 15 |
| Leasehold improvements | Over the shorter of the related lease period or the life of the asset |

DSP GROUP INC. AND ITS SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

Intangible assets

Intangible assets are amortized over their useful life using a method of amortization that reflects the pattern in which the economic benefits of the intangible assets are consumed or otherwise used up, in accordance with SFAS No. 142. Intangible assets are amortized over a period of four years.

Impairment of long-lived assets

The long-lived assets and certain identifiable intangibles of the Company and its subsidiaries are reviewed for impairment, in accordance with SFAS No. 144, "Accounting for the Impairment or Disposal of Long-Lived Assets," whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. The recoverability of assets to be held and used is measured by a comparison of the carrying amount of such assets to the future undiscounted cash flows expected to be generated by the assets. If such assets are considered to be impaired, the impairment to be recognized is measured by the amount by which the carrying amount of the assets exceeds the fair value of the assets. As of December 31, 2006 and 2005, no impairment losses have been identified.

Goodwill

The Company's investment in VoicePump included the excess of its purchase over the net assets acquired which was attributed to goodwill. SFAS No. 142 requires goodwill and indefinite-lived intangible assets to be tested for impairment at least annually or between annual tests if certain events or indicators of impairment occur. The impairment test consists of a comparison of the fair value of an intangible asset with its carrying amount. If the carrying amount of an intangible asset exceeds its fair value, an impairment loss is recognized in an amount equal to that excess. Goodwill is tested for impairment at the reporting unit level by a comparison of the fair value of a reporting unit with its carrying amount.

During 2006 and 2005, the Company performed the required annual impairment tests of goodwill. Based on management projections and using expected future discounted operating cash flows, no indication of goodwill impairment was identified. For a discussion of the impairment tests conducted in 2004 and the results of such tests, see Note 1.

Severance pay

DSP Group Israel has a liability for severance pay pursuant to Israeli law, based on the most recent monthly salary of its employees multiplied by the number of years of employment as of the balance sheet date for such employees. DSP Group Israel's liability is fully provided by monthly accrual and deposits with severance pay funds and insurance policies.

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

DSP Korea has a liability for severance pay pursuant to Korean law, based on the most recent monthly salary of its employees multiplied by the number of years of employment as of the balance sheet date for such employees. DSP Korea's severance liability has been fully accrued.

Severance expense for the years ended December 31, 2006, 2005 and 2004, was approximately \$1,358, \$923 and \$1,229, respectively.

DSP GROUP INC. AND ITS SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

Employee benefit plan

The Company has a 401(K) deferred compensation plan covering all employees in the U.S. All eligible employees may elect to contribute up to 75% of their compensation to the plan through salary deferrals, subject to IRS limits. The maximum deferral for calendar year 2006 was \$15 (\$20, if the employee reached the age of 50 by December 31, 2006). The Company currently offers an employer matching program. This matching contribution currently is 25% of the employee contribution up to a maximum of 1% of the employee's compensation per year. This matching contribution vests 25% per year over the first four years of the employee's service to the Company.

Revenue recognition

The Company and its subsidiaries generate their revenues from sales of products. The Company and its subsidiaries sell their products through a direct sales force and through a network of distributors and representatives. Revenue is recognized when title to the product passes to the customer.

Product sales are recognized in accordance with SEC Staff Accounting Bulletin No. 104, "Revenue Recognition" ("SAB No. 104") when persuasive evidence of an agreement exists, delivery of the product has occurred, the fee is fixed or determinable, collectability is reasonably assured, and no significant obligations remain.

Product revenues on shipment to distributors are deferred until the distributors resell the Company's products to the end-customers ("sell through") based upon receipt of reports from the distributors, provided all other revenue recognition criteria are met.

The Company does not grant any rights of return.

Warranty

The Company warrants its products against errors, defects and bugs for generally one year. The Company estimates the costs that may be incurred under its warranty and records a liability in the amount of such costs. The Company periodically assesses the adequacy of its recorded warranty liabilities and adjusts the amounts as necessary. Warranty costs and liability were immaterial for the years ended December 31, 2006, 2005 and 2004.

Research and development costs

Research and development costs are charged to the consolidated statement of income as incurred.

Stock based compensation

At December 31, 2006, the Company has five stock-based employee compensation plans, which are described more fully in Note 8. Prior to January 1, 2006, the Company accounted for those plans under the recognition and measurement provisions of APB Opinion No. 25, "Accounting for Stock Issued to Employees" ("Opinion 25"), and related Interpretations, as permitted by FASB Statement No. 123, "Accounting for Stock-Based Compensation" ("Statement 123"). No stock-based employee compensation cost was recognized in the statement of income for the years ended December 31, 2005 and 2004, as all options granted under those plans had an exercise price equal to the market value of the underlying common stock on the date of grant.

Effective January 1, 2006, the Company adopted the fair value recognition provisions of FASB Statement No. 123(R), "Share-Based Payment" ("Statement 123(R)"), using the modified-prospective-transition method. Under that transition method, compensation cost recognized during 2006 included:

(a) compensation cost for all

DSP GROUP INC. AND ITS SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

share-based payments granted prior to, but not yet vested as of January 1, 2006, based on the grant date fair value estimated in accordance with Statement 123, and (b) compensation cost for all share-based payments granted subsequent to January 1, 2006, based on the grant-date fair value estimated in accordance with the provisions of Statement 123(R). Results for prior periods have not been restated.

As a result of adopting Statement 123(R) on January 1, 2006, the Company's income before taxes on income and net income for the year ended December 31, 2006, were \$12,123 and \$11,633 lower, respectively, than if it had continued to account for share-based compensation under Opinion 25. Basic and diluted earnings per share for the year ended December 31, 2006, were \$0.40 and \$0.39 lower, respectively, than if the Company had continued to account for share-based compensation under Opinion 25.

Prior to the adoption of Statement 123(R), the Company presented all tax benefits of deductions resulting from the exercise of stock options as operating cash flows in the statement of cash flows. Statement 123(R) requires the cash flows resulting from the tax benefits resulting from tax deductions in excess of the compensation cost recognized for those options (excess tax benefits) to be classified as financing cash flows. The \$643 excess tax benefit classified as a financing cash inflow would have been classified as an operating cash inflow if the Company had not adopted Statement 123(R).

The following table illustrates the effect on net income and earnings per share if the Company had applied the fair value recognition provisions of Statement 123 to options granted under the Company's stock option plans in all periods presented. For purposes of this pro forma disclosure, the value of the options is estimated using a Black-Scholes option-pricing formula and amortized to expense over the options' vesting periods.

| | Year ended December 31, | |
|---|--------------------------------|-------------|
| | 2005 | 2004 |
| Net Income, as reported | 29,473 | 51,094 |
| Add: Stock-based employee compensation expense included in reported net income, net of related tax effects | — | — |
| Deduct: Total stock-based employee compensation expense determined under fair value based method for all awards, net of related tax effects | 9,899 | 10,570 |
| Pro forma net income | 19,574 | 40,524 |
| Earnings per share | | |
| Basic—as reported | \$ 1.04 | \$ 1.79 |
| Basic—pro forma | \$ 0.69 | \$ 1.42 |
| Diluted—as reported | \$ 0.99 | \$ 1.70 |
| Diluted—pro forma | \$ 0.66 | \$ 1.35 |

The pro forma effects of estimated equity-based compensation expense on net income and earnings per share for the two years ended December 31, 2005 and 2004 were estimated at the date of grant using the Black-Scholes model based on the following assumptions (annualized percentages):

| | Year ended December 31, | |
|-------------------------|--------------------------------|-------------|
| | 2005 | 2004 |
| Volatility | 36% | 38% |
| Risk-free interest rate | 3.97% | 3.23% |
| Dividend yield | 0% | 0% |
| Expected life (years) | 2.9-3.3 | 2.9-3.3 |

DSP GROUP INC. AND ITS SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

As of December 31, 2006, the total unrecognized estimated compensation cost related to non-vested stock options granted prior to that date was \$12,066, which is expected to be recognized over a period of up to four years. The total intrinsic value of stock options exercised during 2006 was \$18,768. The Company recorded cash received from the exercise of stock options of \$33,561 and related tax benefits of \$675 during the year ended December 31, 2006.

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 year. Diluted net earnings per share further include the dilutive effect of stock options outstanding during the year, all in accordance with Statement of Financial Accounting Standard No. 128, "Earnings per Share" ("SFAS No. 128").

Options outstanding to purchase 3,499,165, 1,620,293 and 3,963,202 shares of common stock for the years ended December 31, 2006, 2005 and 2004, respectively, were not included in the computation of diluted net earnings per share, because option exercise prices were greater than the average market price of the common stock and, therefore, their inclusion would have been anti-dilutive.

Income taxes

The Company and its subsidiaries account for income taxes in accordance with Statement of Financial Accounting Standard No. 109, "Accounting for Income Taxes" ("SFAS No. 109"). This statement prescribes the use of the liability method, whereby deferred tax asset and liability account balances are determined based on differences between financial reporting and tax bases of assets and liabilities and are measured using the enacted tax rates that will be in effect when the differences are expected to reverse. The Company and its subsidiaries provide a valuation allowance, if necessary, to reduce deferred tax assets to their estimated realizable value.

Concentrations of credit risk

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

The majority of cash and cash equivalents of the Company and its subsidiaries is invested in U.S. dollar deposits with major U.S. and Israeli banks. Such cash and cash equivalents in U.S. banks may be in excess of insured limits and are not insured in other jurisdictions. Management believes that the financial institutions that hold the deposits and investments of the Company and its subsidiaries are financially sound and, accordingly, minimal credit risk exists with respect to these deposits and investments.

A majority of the product sales of the Company and its subsidiaries is to distributors who in turn, sell to original equipment manufacturers of consumer electronics products. The customers of the Company and its subsidiaries are located primarily in Japan, Hong Kong, Taiwan, Korea, Europe and the United States. The Company and its subsidiaries perform ongoing credit evaluations of their customers. A general and specific allowance for doubtful accounts is determined, based on management's estimation and historical experience. Under certain circumstances, the Company may require a letter of credit. The Company covers most of its customer receivables through credit insurance. Allowance for doubtful accounts amounted to \$0 and \$50 as of December 31, 2006 and 2005, respectively.

DSP GROUP INC. AND ITS SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

The Company's held-to-maturity marketable securities include investments in debentures of U.S. corporations, state and political subdivisions. Management believes that those corporations and state institutions are financially sound, the portfolio is well diversified and, accordingly, that minimal credit risk exists with respect to these marketable securities.

The Company and its subsidiaries have no off-balance-sheet concentration of credit risk, except for certain derivative instruments as mentioned below.

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 their derivative instruments as either assets or liabilities in the statement of financial position at fair value.

For derivative instruments that are designated and qualify as a cash flows 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 flows 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 rent of its Israeli facilities denominated in NIS for a period of one to 12 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 December 31, 2006, the Company recorded accumulated other comprehensive income amounting to \$28 from its put options and forward contracts with respect to payroll and rent payments expected in 2007. Such amounts will be recorded under earnings in 2007.

The Company's recognized net gains (losses) were immaterial during the years ended December 31, 2006, 2005 and 2004, related to the put options and forward contracts.

New Accounting Pronouncements

In July 2006, the Financial Accounting Standards Board ("FASB") issued Financial Interpretation No. 48, "Accounting for Uncertainty in Income Taxes" ("FIN 48"), which applies to all tax positions related to income taxes subject to Statement of Financial Accounting Standard No. 109, "Accounting for Income Taxes." FIN 48 requires a new evaluation process for all tax positions taken. If the probability for sustaining said tax position is greater than 50%, then the tax position is recorded and recognition should be at the highest amount that is greater than 50% likely of being realized upon ultimate settlement. FIN 48 requires expanded disclosure at each annual reporting period, unless a significant change occurs in an interim period. Differences between the amount recognized in the statements of financial position prior to the adoption of FIN 48 and the amounts reported after adoption should be accounted for as an adjustment to the beginning balance of retained earnings. FIN 48 is effective for fiscal years beginning after December 15, 2006.

DSP GROUP INC. AND ITS SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

The Company is currently evaluating the impact of the adoption of FIN 48 and has not yet determined what impact, if any, it will have on the Company's financial statements.

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 within those fiscal years. The Company does not anticipate any material impact on its consolidated financial statements upon the adoption of SFAS No. 157.

Staff Accounting Bulletin (SAB) No. 108, "Considering the Effects of a Prior Year Misstatements When Quantifying Misstatements in Current Year Financial Statements" ("SAB 108") addresses how the effects of prior year uncorrected errors must be considered in quantifying misstatements in the current year financial statements. The effects of prior year uncorrected errors include the potential accumulation of improper amounts that may result in a material misstatement on the balance sheet or the reversal of prior period errors in the current period that result in a material misstatement of the current period income statement amounts. Adjustments to current or prior period financial statements would be required in the event that after application of various approaches for assessing materiality of a misstatement in current period financial statements and consideration of all relevant quantitative and qualitative factors, a misstatement is determined to be material. SAB 108 is applicable to all financial statements issued by the Company after November 15, 2006. The adoption of SAB 108 did not have any effect on the Company's consolidated financial statements.

NOTE 3:- MARKETABLE SECURITIES

The following is a summary of held-to-maturity securities at December 31, 2006 and 2005:

| | Amortized cost | | Unrealized losses, net | | Estimated fair value | |
|--|-------------------|-------------------|------------------------|-------------------|----------------------|-------------------|
| | 2006 | 2005 | 2006 | 2005 | 2006 | 2005 |
| US government obligations and political subdivisions | \$ 180,684 | \$ 164,257 | \$ (2,225) | \$ (3,596) | \$ 178,459 | \$ 160,661 |
| Corporate obligations | 108,156 | 93,446 | (775) | (1,416) | 107,381 | 92,030 |
| | <u>\$ 288,840</u> | <u>\$ 257,703</u> | <u>\$ (3,000)</u> | <u>\$ (5,012)</u> | <u>\$ 285,840</u> | <u>\$ 252,691</u> |

The amortized cost of held-to-maturity debt securities at December 31, 2006, by contractual maturities, are shown below:

| | Amortized cost | Unrealized gains (losses) | | Estimated fair value |
|----------------------------------|-------------------|---------------------------|-------------------|----------------------|
| | | Gains | (Losses) | |
| Due in one year or less | \$ 109,472 | \$ 1 | \$ (789) | \$ 108,684 |
| Due after one year to five years | 179,368 | 76 | (2,288) | 177,156 |
| | <u>\$ 288,840</u> | <u>\$ 77</u> | <u>\$ (3,077)</u> | <u>\$ 285,840</u> |

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

DSP GROUP INC. AND ITS SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

Unrealized losses that are not deemed to be other-than-temporarily impaired, aggregated by length of time that individual securities have been in a continuous unrealized loss position, at December 31, 2006 for less than 12 months amounted to \$347 and for 12 months or greater amounted to \$2,730.

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 investments were not considered to be other-than-temporarily impaired at December 31, 2006.

NOTE 4:- INVENTORIES

Inventories are composed of the following:

| | December 31, | |
|-------------------|--------------|-----------|
| | 2006 | 2005 |
| Work-in-progress | \$ 5,248 | \$ 7,145 |
| Finished products | 9,118 | 5,541 |
| | \$ 14,366 | \$ 12,686 |

NOTE 5:- PROPERTY AND EQUIPMENT

Composition of assets, grouped by major classifications, is as follows:

| | December 31, | |
|--------------------------------|--------------|-----------|
| | 2006 | 2005 |
| Cost: | | |
| Computers and equipment | \$ 39,317 | \$ 32,690 |
| Office furniture and equipment | 1,322 | 1,232 |
| Motor vehicles | 102 | 115 |
| Leasehold improvements | 3,850 | 3,613 |
| | 44,591 | 37,650 |
| Less—accumulated depreciation | 31,947 | 25,946 |
| Depreciated cost | \$ 12,644 | \$ 11,704 |

Depreciation expenses amounted to \$6,001, \$4,599 and \$2,506 for the years ended December 31, 2006, 2005 and 2004, respectively.

NOTE 6:- INVESTMENTS IN EQUITY SECURITIES OF TRADED COMPANIES

a. AudioCodes Ltd.

AudioCodes Ltd. ("AudioCodes") is an Israeli corporation primarily engaged in the design, research, development, manufacturing and marketing of hardware and software products that enable simultaneous transmission of voice and data over networks. The Company acquired an approximate 35% ownership in AudioCodes in two separate transactions in 1993 and 1994.

DSP GROUP INC. AND ITS SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

Since April 1, 2001, the Company has not had significant influence over the operating and financial policies of AudioCodes, and thus ceased accounting for this investment under the equity method of accounting. As of April 1, 2001, the investment in AudioCodes was reclassified and accounted for as available-for-sale marketable securities in accordance with SFAS No. 115.

During the first quarter of 2004, the Company sold 2,000,000 shares of AudioCodes' ordinary shares for gross proceeds of approximately \$25,647, resulting in a capital gain of approximately \$20,827. During the second quarter of 2004, the Company sold 801,000 of AudioCodes' ordinary shares for gross proceeds of approximately \$9,600, resulting in a capital gain of approximately \$7,670.

During the third quarter of 2004, the Company sold the remaining 1,650,000 of AudioCodes ordinary shares for gross proceeds of \$19,436, resulting in a capital gain of approximately \$15,459. The Company no longer has any equity interest in AudioCodes.

b. Tomen Corporation:

In September 2000, the Company invested approximately \$485 (¥50.0 million) in shares of its largest distributor's parent company, Tomen Ltd. ("Tomen"), a Japanese distributor (see Note 1), as part of a long strategic relationship. Tomen's shares are traded on the Japanese stock exchange. The Company accounted for its investment in Tomen in accordance with SFAS No. 115 as available for sale marketable securities.

During the first quarter of 2004, the Company sold all of its holdings in Tomen for gross proceeds of approximately \$773, resulting in a capital gain of approximately \$490.

NOTE 7:- INTANGIBLE ASSETS, NET

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

| | December 31, | |
|---------------------------|-----------------|-----------------|
| | 2006 | 2005 |
| Cost: | | |
| Patents | \$ 4,009 | \$ 4,009 |
| Workforce | 570 | 570 |
| | <u>4,579</u> | <u>4,579</u> |
| Accumulated amortization: | | |
| Patents | 2,870 | 1,869 |
| Workforce | 515 | 373 |
| | <u>3,385</u> | <u>2,242</u> |
| Amortized cost | <u>\$ 1,194</u> | <u>\$ 2,337</u> |

Intangible assets mainly represent patents acquired-upon the purchase of substantially all of the assets of Bermai in 2004 and the acquisition of Teleman Multimedia Inc. in 2003. Neither of these acquisitions qualified under EITF 98-3 for business combination accounting.

b. Amortization expenses amounted to \$1,143, \$1,145 and \$718 for the years ended December 31, 2006, 2005 and 2004, respectively.

DSP GROUP INC. AND ITS SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

c. Estimated amortization expenses for the years ended:

| | |
|-------------------------|-----------------|
| Year ended December 31, | |
| 2007 | \$ 766 |
| 2008 | 428 |
| | <u>\$ 1,194</u> |

NOTE 8:- STOCKHOLDERS' EQUITY

Preferred stock

The Company's Board of Directors has the authority, without any further vote or action by the stockholders, to provide for the issuance of up to 5,000,000 shares of preferred stock in one or more series with such designations, rights, preferences, and limitations as the Board of Directors may determine, including the consideration received, the number of shares comprising each series, dividend rates, redemption provisions, liquidation preferences, sinking fund provisions, conversion rights and voting rights. No shares of preferred stock are currently outstanding.

Common stock

Currently, 50,000,000 shares of common stock are authorized. Holders of the common stock are entitled to one vote per share on all matters to be voted upon by the Company's stockholders. Subject to the rights of the holders of the preferred stock, if any, in the event of liquidation, dissolution or winding up, holders of the common stock are entitled to share ratably in all of the Company's assets. The Company's Board of Directors may declare a dividend out of funds legally available therefore and, subject to the rights of the holders of the preferred stock, if any, the holders of common stock are entitled to receive ratably any such dividends.

Holders of common stock have no preemptive rights or other subscription rights to convert their shares into any other securities. There are no redemption or sinking fund provisions applicable to the common stock.

Dividend policy

At December 31, 2006, the Company had retained earnings of \$195,198. The Company has never paid cash dividends on the common stock and presently intends to follow a policy of retaining earnings for reinvestment in its business.

Share repurchase program

In October 2004, the Board of Directors authorized 2.5 million shares of common stock for repurchase under the share repurchase program, increasing the total shares authorized to be repurchased to 9 million shares. In 2006, 2005 and 2004, the Company repurchased 2,242,000, 682,000 and 1,577,000 shares, respectively, of common stock at an average purchase price of \$23.57, \$24.98 and \$20.09 per share, respectively, for an aggregate purchase price of \$52,848, \$17,038 and \$31,697, respectively. As of December 31, 2006, 772,000 shares of common stock remain authorized for repurchase.

The repurchases of common stock are accounted for as treasury stock, and result in a reduction of stockholders' equity. When treasury shares are reissued, the Company accounts for the reissuance in accordance with Accounting Principles Board Opinion No. 6, "Status of Accounting Research Bulletins" and charges the excess of the repurchase cost over issuance price using the weighted average method to retained earnings. In the case where the repurchasing cost over issuance price using the weighted average method is lower than the issuance price, the Company credits the difference to additional paid-in capital.

DSP GROUP INC. AND ITS SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

In 2006, 2005 and 2004, the Company issued 1,172,000, 1,324,000 and 145,000 shares, respectively, of common stock, out of treasury stock, to employees who have exercised their stock options or purchased shares from the Company's 1993 Employee Stock Purchase Plan ("ESPP").

Stock purchase plan and stock option plans

The Company has various stock option plans under which employees, consultants, officers, and directors of the Company and its subsidiaries may be granted options to purchase common stock. The plans authorize the administrator to grant incentive stock options at an exercise price of not less than 100% of the fair market value of the common stock on the date the option is granted and non-qualified stock options. It is the Company's policy to grant options at the fair market value.

Options granted under all stock incentive plans that are cancelled or forfeited before expiration become available for future grant. A summary of the various plans is as follows:

During 2006, the Company granted its employees, including executive officers, a new equity-based award instrument—a net Share Appreciation Right ("SAR"), capped with a ceiling, under its various stock option plans. The SAR unit confers the right to stock appreciation over a preset price during a specified period of time. When the unit is exercised, the appreciation amount is paid by the issuance of shares. The ceiling limits the maximum income for each SAR unit. A SAR is considered as an equity instrument as it is a net share settled award capped with a ceiling. The Company measures these awards under SFAS 123(R).

1993 director stock option plan

Upon the closing of the Company's initial public offering, the Company adopted the 1993 Director Stock Option Plan (the "Directors Plan"). Under the Directors Plan, which expires in 2014, the Company is authorized to issue nonqualified stock options to the Company's outside, non-employee directors to purchase up to 1,380,875 shares of common stock at an exercise price equal to the fair market value of the common stock on the date of grant. The Directors Plan, as amended, provides that each person who becomes an outside, non-employee director of the Board of Directors shall automatically be granted an option to purchase 30,000 shares of common stock (the "First Option").

Thereafter, each outside director shall automatically be granted an option to purchase 15,000 shares of common stock (a "Subsequent Option") on January 1 of each year if, on such date, he shall have served on the Board of Directors for at least six months. In addition, an option to purchase an additional 15,000 shares of common stock (a "Committee Option") is granted on January 1 of each year to each outside director for each committee of the Board on which he shall have served as a chairperson for at least six months.

Options granted under the Directors Plan generally have a term of 10 years. One-third of the shares are exercisable after the first year and thereafter one-third at the end of each twelve-month period.

As of December 31, 2006, 383,272 shares of common stock remain available for grant under that plan.

1998 Non-Officer Employee Stock Option Plan

In 1998, the Company adopted the 1998 Non-Officer Employee Stock Option Plan (the "1998 Plan"). Under the 1998 Plan, employees may be granted non-qualified stock options for the purchase of common stock. The 1998 Plan expires in 2008 and currently provides for the purchase of up to 5,062,881 shares of common stock. As of December 31, 2006, 130,712 shares of common stock remain available for grant under that plan.

DSP GROUP INC. AND ITS SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

The exercise price of options under the 1998 Plan shall not be less than the fair market value of common stock for nonqualified stock options, as determined by the Company's Board of Directors.

Options under the 1998 Plan are generally exercisable over a 48-month period beginning 12 months after issuance, or as determined by the Company's Board of Directors. Options under the 1998 Plan expire up to seven years after the date of grant.

2001 Stock Incentive Plan

In 2001, the Company adopted the 2001 Stock Incentive Plan (the "2001 Plan"). Under the 2001 Plan, employees, directors and consultants may be granted incentive or non-qualified stock options and other awards for the purchase of common stock. The 2001 Plan expires in 2011. 1,526,314 shares of common stock are currently reserved for issuance under the 2001 Plan. As of December 31, 2006, 204,421 shares of common stock remain available for grant under that plan.

The 2001 Plan authorizes the administrator to grant incentive stock options at an exercise price of not less than 100% of the fair market value of the common stock on the date the option is granted.

Options under the 2001 Plan are generally exercisable over a 48-month period beginning 12 months after issuance or as determined by the Company's Board of Directors. Options under the 2001 Plan expire up to seven years after the date of grant.

2003 Israeli Share Option Plan

In 2003, the Company adopted the 2003 Israeli Share Option Plan (the "2003 Plan"), which complies with the Israeli tax reforms. Qualified options and shares are held in trust until the later of 24 months from the date of grant of the options, or the vesting of the options based on a vesting schedule determined by a committee appointed by the Company's Board of Directors. 4,499,930 shares of common stock were reserved for issuance as of December 31, 2006 under this plan. Pursuant to the terms of the 2003 Plan, on the first business day of each calendar year beginning in 2004, the number of shares authorized under the plan increases by an amount equal to 3% of the number of shares of common stock outstanding as of such date, or a lower number of shares determined by the Company's Board of Directors. As of December 31, 2006, 516,667 shares of common stock remain available for grant under the 2003 Plan. The 2003 Plan expires in 2013.

Options under the 2003 Plan are generally exercisable over a 48-month period beginning 12 months after issuance, or as determined by the Board of Directors. Options under the 2003 Plan expire up to seven years after the date of grant.

1993 Employee Stock Purchase Plan

Upon the closing of the Company's initial public offering, the Company adopted the ESPP. The Company has reserved an aggregate amount of 1,000,000 shares of common stock for issuance under the ESPP. The ESPP provides that substantially all employees may purchase stock at 85% of its fair market value on specified dates via payroll deductions. There were approximately 80,000, 74,000 and 70,000, shares issued at a weighted average exercise price of \$18.85, \$18.69 and \$13.61 under the ESPP in 2006, 2005 and 2004, respectively.

DSP GROUP INC. AND ITS SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

Stock reserved for future issuance

The following table summarizes the number of outstanding shares of common stock available for future issuance at December 31, 2006:

| | <u>In thousands</u> |
|------------------------------|---------------------|
| Employee stock purchase plan | 286 |
| Stock options | 1,235 |
| Undesignated preferred stock | 5,000 |
| | 6,521 |

The following is a summary of activities relating to the Company's stock options and SARs granted among the Company's various plans:

| | Year ended December 31, | | | | | |
|--|-------------------------|---------------------------------------|----------------------|---------------------------------------|----------------------|---------------------------------------|
| | 2006 | | 2005 | | 2004 | |
| | Amount of options | Weighted average exercise price | Amount of options | Weighted average exercise price | Amount of options | Weighted average exercise price |
| | In thousands | | In thousands | | In thousands | |
| Options outstanding at beginning of year | 7,664 | \$ 22.27 | 8,001 | \$ 20.97 | 7,671 | \$ 20.12 |
| Changes during the year: | | | | | | |
| Granted | 1,768 | \$ 27.50 | 1,257 | \$ 23.99 | 1,569 | \$ 23.41 |
| Exercised | (1,944) | \$ 17.39 | (1,249) | \$ 15.20 | (846) | \$ 15.58 |
| Forfeited and cancelled | (1,023) | \$ 25.79 | (345) | \$ 23.83 | (393) | \$ 25.05 |
| Options outstanding at end of year | 6,465 | \$ 24.61 | 7,664 | \$ 22.27 | 8,001 | \$ 20.97 |
| Options exercisable at end of year | 3,411 | \$ 23.67 | 4,699 | \$ 22.15 | 4,349 | \$ 21.12 |

As of December 31, 2006, the total unrecognized estimated compensation cost related to non-vested stock options granted prior to that date was \$12,066, which is expected to be recognized over a period of up to four years.

As of December 31, 2006, outstanding SARs were 1,465 and the calculation of shares to be settled based on the share price of the Company's common stock as of December 29, 2006 (\$21.70 per share) were 19.

DSP GROUP INC. AND ITS SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

The options and SARs outstanding as of December 31, 2006, have been separated into ranges of exercise price as follows:

| Range of exercise price | Outstanding Thousands | Remaining contractual life (years) | Aggregate intrinsic value(*) | Weighted average exercise price | Exercisable Thousands | Remaining contractual life (years) | Aggregate intrinsic value(*) | Weighted average exercise price |
|-------------------------|--------------------------|--|------------------------------------|---------------------------------------|--------------------------|--|------------------------------------|---------------------------------------|
| \$11.48 – 14.15 | 426 | 2.21 | | \$ 12.52 | 426 | 2.21 | | \$ 12.52 |
| \$15.18 – 19.97 | 554 | 3.1 | | \$ 17.60 | 439 | 2.93 | | \$ 17.39 |
| \$20.06 – 28.72 | 4,730 | 5.35 | | \$ 25.19 | 1,791 | 4.33 | | \$ 23.95 |
| \$30.23 – 42.73 | 755 | 0.47 | | \$ 32.97 | 755 | 0.47 | | \$ 32.97 |
| | <u>6,465</u> | | <u>6,435</u> | <u>\$ 24.61</u> | <u>3,411</u> | | <u>6,004</u> | <u>\$ 23.67</u> |

(*) Calculation of aggregate intrinsic value is based on the share price of the Company's common stock as of December 29, 2006 (\$21.70 per share).

The weighted-average estimated fair value of employee stock options and SARs granted during the 12 months ended December 31, 2006, was \$9.31, per share using the binomial model with the following weighted-average assumptions (annualized percentages):

| | Year ended December 31, 2006 |
|--------------------------------|------------------------------------|
| Volatility | 37.78% |
| Risk-free interest rate | 4.79% |
| Dividend yield | 0% |
| Pre-vest cancellation rate*) | 7.31% |
| Post-vest cancellation rate**) | 1.08% |
| Suboptimal exercise factor***) | 1.73 |
| Expected life | 4.64 years |

*) The pre-vest cancellation rate was calculated on an annual basis, the rate presented here is that of the total cancellations from grant.

***) The post-vest cancellation rate was calculated on a monthly basis and is presented here on an annual basis.

***) The ratio of the stock price to strike price at the time of exercise of the option.

The Company used its historical volatility and its implied volatility for calculating volatility in accordance with SFAS 123(R). The computation of volatility uses a combination of historical volatility and implied volatility derived from the company's exchange traded options with similar characteristics. As a result of the above-mentioned calculations, the weighted-average volatility used for the 12 months ended December 31, 2006 was 37.78%.

The risk-free interest rate assumption is based on observed interest rates appropriate for the term of the Company's employee stock options. Weighted average interest rate used for the 12 months ended December 31, 2006 was 4.79%.

The Company is required to assume a dividend yield as an input in the binomial model. The dividend yield assumption is based on the Company's historical and expectation of future dividend payouts and may be subject to substantial change in the future. The dividend yield used for the twelve months ended December 31, 2006 was 0%.

DSP GROUP INC. AND ITS SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

The expected life of employee stock options represents the weighted-average period the stock options are expected to remain outstanding and is a derived output of the binomial model. The expected life of 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 on past option grants made by the Company. The expected life for options granted during the 12 months ended December 31, 2006 derived from the binomial model was 4.64 years.

As equity-based compensation expense recognized in the consolidated statement of income is based on awards ultimately expected to vest, it should be reduced for estimated forfeitures. Statement 123(R) requires forfeitures to be estimated at the time of grant and revised, if necessary, in subsequent periods if actual forfeitures differ from those estimates. Pre-vesting forfeitures were estimated to be approximately 7.31% in the twelve months ended December 31, 2006, based on historical experience (post-vesting forfeitures rate was 1.08% and is included in the valuation above).

The Company's aggregate compensation cost for the 12 months ended December 31, 2006 totaled \$12,123 thousand. The total income tax benefit recognized in the income statement for the 12 months ended December 31, 2006, was \$490, for the Company's equity-based compensation arrangements.

The total equity-based compensation expense related to all of the Company's equity-based awards, recognized for 12 months ended December 31, 2006, was comprised as follows:

| | Year ended December 31, 2006 |
|---|---|
| Cost of goods sold | \$ 461 |
| Research and development | 6,353 |
| Sales and Marketing | 1,319 |
| General and administrative | 3,990 |
| Total equity-based compensation expense before taxes | <u>\$ 12,123</u> |
| Related income tax benefits | \$ (490) |
| Equity-based compensation expense, net of taxes | 11,634 |
| Net equity-based compensation expense, per share of common stock: | |
| Basic | <u>\$ 0.40</u> |
| Diluted | <u>\$ 0.39</u> |

A summary of the status of the Company's nonvested shares as of December 31, 2006, and changes during the year ended December 31, 2006, is presented below:

| Nonvested shares | Shares | Weighted average grant date fair value |
|---------------------------------|-----------------------|---|
| | (In thousands) | \$ |
| Non-vested at January 1, 2006 | 2,965 | 7.02 |
| Granted | 1,768 | 8.78 |
| Vested | (1,266) | (7.19) |
| Forfeited | (413) | (6.81) |
| Non-vested at December 31, 2006 | <u>3,054</u> | <u>8.40</u> |

DSP GROUP INC. AND ITS SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

As of December 31, 2006, there was \$12,066 of total unrecognized compensation cost related to nonvested share-based compensation arrangements granted under the plans. That cost is expected to be recognized over the period from 2007 through 2010.

NOTE 9:- MAJOR CUSTOMERS AND GEOGRAPHIC INFORMATION

The Company operates in one reportable segment (see Note 1 for a brief description of the Company's business).

The following is a summary of operations within geographic areas based on customer locations:

| | Year ended December 31, | | |
|------------------------------|--------------------------------|-------------------|-------------------|
| | 2006 | 2005 | 2004 |
| Revenue distribution: | | | |
| United States | \$ 789 | \$ 1,101 | \$ 1,238 |
| Japan | 144,821 | 141,310 | 119,052 |
| Europe | 1,035 | 699 | 1,831 |
| Hong-Kong | 59,854 | 33,521 | 27,700 |
| Other | 10,449 | 10,594 | 7,690 |
| | <u>\$ 216,948</u> | <u>\$ 187,225</u> | <u>\$ 157,511</u> |

The following is a summary of long-lived assets within geographic areas based on the assets locations:

| | December 31, | | |
|---------------------------|---------------------|------------------|------------------|
| | 2006 | 2005 | 2004 |
| Long-lived assets: | | | |
| United States | \$ 4,834 | \$ 6,042 | \$ 4,270 |
| Israel | 7,367 | 8,357 | 5,563 |
| Other | 3,137 | 1,142 | 1,832 |
| | <u>\$ 15,338</u> | <u>\$ 15,541</u> | <u>\$ 11,665</u> |

The following is a summary of revenues from major customers:

| | Year ended December 31, | | |
|--------------|--------------------------------|-------------|-------------|
| | 2006 | 2005 | 2004 |
| | | % | |
| Customer A*) | 39% | 49% | 51% |
| Customer B*) | 14% | 18% | 20% |
| Customer C | 17% | 13% | 17% |
| Customer D | 11% | 5% | — |

*) These revenues were generated through Tomen Electronics, the Company's largest distributor.

NOTE 10:- COMMITMENTS AND CONTINGENCIES

Commitments

The Company and its subsidiaries lease certain equipment and facilities under non-cancelable operating leases. The Company has significant leased facilities in Herzliya Pituach, Israel and in California. The lease agreement for the Israeli facilities is effective until November 2008. The Company has various agreements for its

DSP GROUP INC. AND ITS SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

facilities in the U.S. terminating in 2007-2010. In November 2004, DSP Japan entered into a new facility in Tokyo, Japan. This new lease is effective until October 2008. The Company's subsidiaries in Korea and Scotland have lease agreements for their facilities that terminate in 2007. The Company has operating lease agreements for its motor vehicles, which terminate in 2007 to 2009.

At December 31, 2006, the Company is required to make the following minimum lease payments under non-cancelable operating leases for its motor vehicles and facilities:

| Year ended December 31, | |
|--------------------------------|-----------------|
| 2007 | \$ 2,982 |
| 2008 | 2,247 |
| 2009 | 694 |
| 2010 | 120 |
| | <u>\$ 6,043</u> |

Claims

- a. The Company is involved in certain claims arising in the normal course of business. However, the Company believes that the ultimate resolution of these matters will not have a material adverse effect on its financial position, results of operations, or cash flows.

- b. From time to time, the Company may become involved in litigation relating to claims arising in the ordinary course of business activities. Also, as is typical in the semiconductor industry, the Company has been and, from time to time may be, notified of claims that it may be infringing on 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 recorded a provision, which was included in the costs of revenues, in respect of this legal exposure. The Company and its legal counsel currently believe that there are no claims or actions pending or threatened against it, the ultimate disposition of which would have a material adverse effect on the Company.

DSP GROUP INC. AND ITS SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

NOTE 11:- TAXES ON INCOME

a. The provision for income taxes is as follows:

| | Year ended December 31, | | |
|-----------------|-------------------------|-----------------|------------------|
| | 2006 | 2005 | 2004 |
| Domestic taxes: | | | |
| Federal taxes: | | | |
| Current | \$ 2,669 | \$ 1,157 | \$ 15,637 |
| Deferred*) | 131 | (164) | (2,929) |
| | <u>2,800</u> | <u>993</u> | <u>12,708</u> |
| State taxes: | | | |
| Current | 171 | (30) | 1,159 |
| Deferred | (419) | 68 | (132) |
| | <u>(248)</u> | <u>38</u> | <u>1,027</u> |
| Foreign taxes: | | | |
| Current | 2,039 | 5,196 | 7,679 |
| Deferred | (351) | (190) | 68 |
| | <u>1,688</u> | <u>5,006</u> | <u>7,747</u> |
| Taxes on income | <u>\$ 4,240</u> | <u>\$ 6,037</u> | <u>\$ 21,482</u> |

*) Including \$490 in 2006 related to tax benefit resulting from equity-based compensation expenses.

The tax benefits associated with the exercise of non qualified stock options reduced taxes currently payable by \$675 in 2006, \$845 in 2005 and \$565 in 2004. Such benefits were credited to additional paid-in capital.

b. Income before taxes is comprised as follows:

| | Year ended December 31, | | |
|----------|-------------------------|------------------|------------------|
| | 2006 | 2005 | 2004 |
| Domestic | \$ 5,972 | \$ 5,030 | \$ 47,461 |
| Foreign | 20,647 | 30,480 | 25,115 |
| | <u>\$ 26,619</u> | <u>\$ 35,510</u> | <u>\$ 72,576</u> |

c. A reconciliation between the Company's effective tax rate assuming all income is taxed at statutory tax rate applicable to the income of the Company and the U.S. statutory rate is as follows:

| | Year ended December 31, | | |
|--|-------------------------|-----------------|------------------|
| | 2006 | 2005 | 2004 |
| Income before taxes on income | \$ 26,619 | \$ 35,510 | \$ 72,576 |
| Theoretical tax at U.S. statutory tax rate (35%) | \$ 9,317 | \$ 12,428 | \$ 25,402 |
| State taxes, net of federal benefit | 51 | 25 | 667 |
| Goodwill impairment | — | — | 1,506 |
| Foreign income taxed at rates other than the U.S. rate | (8,431) | (5,662) | (5,514) |
| Nondeductible equity-based compensation expenses | 3,753 | — | — |
| Other individually immaterial items | (450) | (754) | (579) |
| | <u>\$ 4,240</u> | <u>\$ 6,037</u> | <u>\$ 21,482</u> |

DSP GROUP INC. AND ITS SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

- d. Deferred income taxes reflect the net tax effects of temporary differences between the carrying amounts of assets and liabilities for financial reporting purposes and the amounts used for income tax purposes.

| | December 31, | |
|--|--------------|----------|
| | 2006 | 2005 |
| Deferred tax assets (short-term): | | |
| Reserves and accruals | \$ 989 | \$ 1,227 |
| Stock-based compensation | 490 | — |
| Other | 37 | — |
| Total deferred tax assets (short-term) | 1,516 | 1,227 |
| Deferred tax assets (long-term): | | |
| Intangible assets | 1,373 | 1,205 |
| Other | 614 | 433 |
| Total deferred tax assets (long-term) | 1,987 | 1,638 |
| Total deferred tax assets | \$ 3,503 | \$ 2,865 |

Management believes that the deferred net tax assets will be realized based on current levels of future taxable income and potentially refundable taxes. Accordingly, a valuation allowance was not provided. U.S. income taxes and foreign withholding taxes were not provided for a cumulative total of \$92,857 of the undistributed earnings of DSP Group Israel. The Company intends to invest these earnings indefinitely in operations outside the U.S.

- e. Tax benefits under the Law for the Encouragement of Capital Investments, 1959 (“Israeli Law”):

DSP Group Israel’s production facilities have been granted “Approved Enterprise” status under Israeli Law in connection with six separate investment plans.

According to the provisions of such Israeli Law, DSP Group Israel has chosen to enjoy the “alternative benefits track” which is a waiver of grants in return for a tax exemption. Accordingly, DSP Group Israel’s income from an “Approved Enterprise” is tax-exempt for a period of two or four years and is subject to a reduced corporate tax rate of 10%-25% (based on the percentage of foreign ownership) for an additional period of six or eight years, respectively. The tax benefits under these investment plans expire starting from 2005 through 2015.

DSP Group Israel’s first and second plans, which were completed and commenced operations in 1994 and 1996, respectively, are tax exempt for two and four years from the first year they have taxable income, respectively, and are entitled to a reduced corporate tax rate of 10%—25% (based on the percentage of foreign ownership) for an additional period of eight and six years, respectively.

The third plan, which was completed and commenced operations in 1998 is tax exempt for two years, from the first year it has taxable income and is entitled to a reduced corporate tax rate of 10%—25% (based on the percentage of foreign ownership) for an additional period of eight years from the first year it has taxable income.

The fourth, fifth and sixth plans were approved in 1998, 2001 and 2003, respectively, which entitle DSP Group Israel to a corporate tax exemption for a period of two years and to a reduced corporate tax rate of 10%—25% (based on the percentage of foreign ownership) for an additional period of eight years from the first year it has taxable income.

DSP GROUP INC. AND ITS SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

Since DSP Group Israel is operating under more than one approval, its effective tax rate is the result of a weighted combination of the various applicable rates and tax exemptions and the computation is made for income derived from each program on the basis and formulas specified in the law and in the approvals.

Through December 31, 2006, DSP Group Israel met all the conditions required under these approvals, which include an obligation to invest certain amounts in property and equipment and an obligation to finance a percentage of investments by share capital.

Should DSP Group Israel fail to meet such conditions in the future, it could be subject to corporate tax in Israel at the standard tax rate and could be required to refund tax benefits already received.

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

As of December 31, 2006, approximately \$31,185 was derived from tax exempt profits earned by DSP Group Israel's "Approved Enterprises." The Company's Boards of Director has determined that such tax-exempt income will not be distributed as dividends and intend to reinvest the amount of its tax exempt income. Accordingly, no deferred income taxes have been provided on income attributable to DSP Group Israel's "Approved Enterprise" as the undistributed tax exempt income is essentially permanent in duration.

If the retained tax-exempt income is distributed in a manner other than on the complete liquidation of the Company, it would be taxed at the corporate tax rate applicable to such profits as if the Company had not elected the alternative tax benefits (currently—10%) and an income tax liability of approximately \$3,465 would be incurred as of December 31, 2006.

Income in DSP Group Israel from sources other than the "Approved Enterprise" during the benefit period will be subject to tax at the effective standard corporate tax rate in Israel.

By virtue of the Israeli Law, DSP Group Israel is entitled to claim accelerated rates of depreciation on equipment used by an "Approved Enterprise" during the first five tax years from the beginning of such use.

On April 1, 2005, an amendment to the Investment Law came into effect (the "Amendment") and has significantly changed the provisions of the Investment Law. The Amendment limits the scope of enterprises which may be approved by the Investment Center by setting criteria for the approval of a facility as an Approved Enterprise, such as provisions generally requiring that at least 25% of the Approved Enterprise's income will be derived from export. Additionally, the Amendment enacted major changes in the manner in which tax benefits are awarded under the Investment Law so that companies no longer require Investment Center approval in order to qualify for tax benefits. The Company believes that it is currently in compliance with these requirements. However, if the Company fails to meet these requirements, it would be subject to corporate tax in Israel at the regular statutory rate (31% for 2006).

However, the Investment Law provides that terms and benefits included in any letter of approval already granted will remain subject to the provisions of the law as they were on the date of such approval. Therefore, DSP Group Israel's existing Approved Enterprises will generally not be subject to the provisions of the Amendment. As a result of the Amendment, tax-exempt income generated under the provisions of the new law, will subject the Company to taxes upon distribution or liquidation and the Company may be required to record a deferred tax liability with respect to such tax-exempt income. As of December 31, 2006, the Company did not generate income under the provision of the new law.

DSP GROUP INC. AND ITS SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

f. Tax benefits under Israel's Law for Encouragement of Industry (Taxation), 1969:

DSP Group Israel is an "industrial company" under the Law for the Encouragement of Industry (Taxation), 1969, and as such is entitled to certain tax benefits, mainly the amortization of costs relating to know-how and patents, over eight years, and accelerated depreciation.

g. Reduction in Israeli tax rate:

Until December 31, 2003, the regular tax rate applicable to income of companies (which are not entitled to benefits due to "Approved Enterprise," as described above) was 36%. In June 2004 and in July 2005, the "Knesset" (Israeli parliament) passed amendments to the Income Tax Ordinance (No. 140 and Temporary Provision), 2004 and (No. 147), 2005 respectively, which determine, among other things, that the corporate tax rate is to be gradually reduced to the following tax rates: 2004—35%, 2005—34%, 2006—31%, 2007—29%, 2008—27%, 2009—26% and 2010 and thereafter—25%.

NOTE 12:- NET EARNINGS PER SHARE

The following table sets forth the computation of basic and diluted net earnings per share:

| | <u>Year ended December 31,</u> | | |
|--|--------------------------------|----------------|----------------|
| | <u>2006</u> | <u>2005</u> | <u>2004</u> |
| Numerator: | | | |
| Net income | \$ 22,379 | \$ 29,473 | \$ 51,094 |
| Denominator: | | | |
| Weighted average number of shares of common stock outstanding during the year used to compute basic net earnings per share (in thousands) | 29,343 | 28,435 | 27,959 |
| Incremental shares attributable to exercise of outstanding options (assuming proceeds would be used to purchase treasury stock) (in thousands) | 706 | 1,408 | 1,133 |
| Weighted average number of shares of common stock used to compute diluted net earnings per share (in thousands) | 30,049 | 29,843 | 29,092 |
| Basic net earnings per share | <u>\$ 0.76</u> | <u>\$ 1.04</u> | <u>\$ 1.79</u> |
| Diluted net earnings per share | <u>\$ 0.74</u> | <u>\$ 0.99</u> | <u>\$ 1.70</u> |