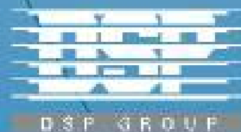
AT HOME IN YOUR WIRELESS WORLD



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[LOGO OF ERNST & YOUNG]

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, 2004 and 2003, 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, 2004. Our audit also included the financial statement schedule listed in the Index at Item 15(a). These financial statements are the responsibility of the Company’s management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with 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, 2004 and 2003, and the consolidated results of their operations and their cash flows for each of the three years in the period ended December 31, 2004, 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.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the effectiveness of DSP Group, Inc. internal control over financial reporting as of December 31, 2004, 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, 2005 expressed, an unqualified opinion thereon.

KOST FORER GABBAY & KASIERER
A Member of Ernst & Young Global

Tel-Aviv, Israel
March 14, 2005

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DSP GROUP, INC. AND ITS SUBSIDIARIES

CONSOLIDATED BALANCE SHEETS
U.S. dollars in thousands

	December 31,	
	2004	2003
ASSETS		
CURRENT ASSETS:		
Cash and cash equivalents	$ 72,102	$ 36,812
Bank deposits	3,038	3,004
Held-to-maturity marketable securities	60,184	39,486
Trade receivables, net	5,976	15,844
Deferred income taxes	1,168	1,326
Other accounts receivable and prepaid expenses	2,213	1,462
Inventories	9,469	8,466
TOTAL CURRENT ASSETS	154,150	106,400
PROPERTY AND EQUIPMENT, NET	6,683	7,108
LONG-TERM ASSETS:		
Long-term held-to-maturity marketable securities	195,671	197,071
Investments in equity securities of traded companies	—	47,138
Long-term prepaid expenses and lease deposits	628	513
Deferred income taxes	1,410	—
Severance pay fund	3,437	2,360
Intangible assets, net	3,482	2,076
Goodwill	1,500	5,804
TOTAL ASSETS	$ 366,961	$ 368,470
LIABILITIES AND STOCKHOLDERS' EQUITY		
CURRENT LIABILITIES:		
Trade payables	$ 7,830	$ 11,221
Accrued compensation and benefits	9,421	9,000
Income taxes payables	17,083	11,107
Accrued expenses and other accounts payable	13,353	14,185
TOTAL CURRENT LIABILITIES	47,687	45,513
LONG-TERM LIABILITIES:		
Accrued severance pay	3,784	2,555
Deferred income taxes	—	14,592
Other long-term liabilities	—	1,429
TOTAL LONG-TERM LIABILITIES	3,784	18,576
STOCKHOLDERS' EQUITY:		
Preferred stock, $ 0.001 par value—Authorized shares—5,000,000 at December 31, 2004 and 2003; Issued and outstanding shares—none at December 31, 2004 and 2003	—	—
Common stock, $0.001 par value—Authorized shares: 50,000,000 at December 31, 2004 and 2003; respectively; Issued and outstanding: 27,954,133 and 28,615,884 shares at December 31, 2004 and 2003, respectively	28	29
Additional paid-in capital	187,471	174,700
Treasury stock	(29,797)	(1,192)
Accumulated other comprehensive income	65	23,045
Retained earnings	157,723	107,799
TOTAL STOCKHOLDERS' EQUITY	315,490	304,381
TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY	$ 366,961	$ 368,470

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

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DSP GROUP, INC. AND ITS SUBSIDIARIES

CONSOLIDATED STATEMENTS OF INCOME
U.S. dollars in thousands, except per share data

	Year ended December 31,		
	2004	2003	2002
Revenues	$ 157,511	$ 152,875	$ 125,158
Costs of revenues	80,368	83,077	74,412
Gross profit	77,143	69,798	50,746
Operating expenses:			
Research and development	32,147	25,599	19,745
Selling and marketing	11,292	11,977	10,745
General and administrative	7,112	6,953	5,048
Impairment of goodwill	4,304	—	—
In-process research and development write-off	2,682	2,727	—
Aborted spin-off expenses and other	—	—	865
Total operating expenses	57,537	47,256	36,403
Operating income	19,606	22,542	14,343
Financial and other income:			
Interest and other income, net	8,522	7,947	9,452
Capital gains from available-for-sale marketable securities	44,448	241	—
Impairment of available-for-sale marketable securities	—	—	(10,229)
Income before taxes on income	72,576	30,730	13,566
Taxes on income	21,482	5,375	894
Income from continuing operations	51,094	25,355	12,672
Income from discontinued operations of Ceva (net of applicable income taxes of $813)	—	—	2,470
Net income	$ 51,094	$ 25,355	$ 15,142
Earnings per share from continuing operations:			
Basic	$ 1.79	$ 0.91	$ 0.47
Diluted	$ 1.70	$ 0.86	$ 0.45
Earnings per share from discontinued operations:			
Basic	$ —	$ —	$ 0.09
Diluted	$ —	$ —	$ 0.09
Net earnings per share:			
Basic	$ 1.79	$ 0.91	$ 0.56
Diluted	$ 1.70	$ 0.86	$ 0.54

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

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DSP GROUP, INC. AND ITS SUBSIDIARIES

STATEMENTS OF CHANGES IN STOCKHOLDERS' EQUITY
U.S. dollars in thousands, except share and per share data

	Number 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, 2002	26,873	$ 27	$ 155,969	$ (8,623)	$ 2,652	$ 128,952		$ 278,977
Dividend to stockholders as a result of the separation of Ceva	—	—	—	—	—	(48,428)		(48,428)
Issuance of treasury stock upon exercise of stock options by employees	314	— *	—	7,463	—	(4,566)		2,897
Issuance of treasury stock upon purchase of ESPP shares by employees	49	— *	—	1,160	—	(328)		832
Issuance of Common stock upon exercise of stock options by employees	12	— *	150	—	—	—		150
Tax benefit related to exercise of stock options	—	—	324	—	—	—		324
Total comprehensive income:								
Net income	—	—	—	—	—	15,142	$ 15,142	15,142
Unrealized losses on available-for-sale marketable securities, net	—	—	—	—	(2,207)	—	(2,207)	(2,207)
Unrealized gain from hedging activities	—	—	—	—	31	—	31	31
Total comprehensive income							$ 12,966	
Balance at December 31, 2002	27,248	27	156,443	—	476	90,772		247,718
Issuance of treasury stock upon purchase of ESPP shares by employees	28	— *	—	603	—	(256)		347
Issuance of Common Stock upon exercise of stock options by employees	1,397	1	17,274	—	—	—		17,275
Issuance of Common Stock upon purchase of ESPP shares by employees	24	— *	298	—	—	—		298
Issuance of treasury stock upon exercise of stock options by employees	665	1	—	14,362	—	(8,072)		6,291
Tax benefit related to exercise of stock options	—	—	685	—	—	—		685
Purchase of treasury stock	(746)	— *	—	(16,157)	—	—		(16,157)
Total comprehensive income:								
Net income	—	—	—	—	—	25,355	$ 25,355	25,355
Unrealized gains on available-for-sale marketable securities, net	—	—	—	—	22,432	—	22,432	22,432
Unrealized gain from hedging activities, net	—	—	—	—	137	—	137	137
Total comprehensive income							$ 47,924	
Balance at December 31, 2003	28,616	$ 29	$ 174,700	$ (1,192)	$ 23,045**	$ 107,799		$ 304,381

* Represents an amount lower than $1.
** Composed as follows:

Accumulated unrealized gain from available-for-sale marketable securities, net of taxes	$ 22,908
Unrealized gain from hedging activities, net	137
Accumulated other comprehensive income	$ 23,045

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

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DSP GROUP, INC. AND ITS SUBSIDIARIES

STATEMENTS OF CHANGES IN STOCKHOLDERS' EQUITY
U.S. dollars in thousands, except share and per share data

	Number 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, 2003	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
Reclassification adjustments—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							$ 28,114	
Balance at December 31, 2004	27,954	$ 28	$ 187,471	$ (29,797)	$ 65**	$ 157,723		$ 315,490

* Represents an amount lower than $1.
** Composed as follows:

Unrealized gain from hedging activities, net	$ 65

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

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DSP GROUP, INC. AND ITS SUBSIDIARIES

CONSOLIDATED STATEMENTS OF CASH FLOWS
U.S. dollars in thousands

	Year ended December 31,		
	2004	2003	2002
Cash flows from operating activities:			
Net income	$ 51,094	$ 25,355	$ 15,142
Adjustments required to reconcile net income to net cash provided by operating activities:			
Depreciation	2,506	3,224	2,589
Increase in deferred income taxes, net	(1,252)	(272)	(3,048)
Net gain on sale of property and equipment	—	(27)	—
Capital gains from available-for-sale marketable securities of traded companies	(44,448)	(241)	(3)
Amortization of intangible assets	718	379	98
Impairment of goodwill	4,304	—	—
In-process research and development write-off	2,682	2,727	—
Accrued interest and amortization of premium (accretion of discount) on held-to-maturity marketable securities	2,321	1,989	2,377
Impairment of available-for-sale marketable securities	—	—	10,229
Tax benefit related to exercise of stock options	565	685	324
Decrease (increase) in trade receivables	9,868	(10,971)	1,442
Decrease (increase) in other accounts receivable and prepaid expenses	(826)	27	546
Increase in inventories	(1,003)	(1,550)	(4,868)
Decrease (increase) in long-term prepaid expenses and lease deposits	(115)	(127)	58
Increase (decrease) in trade payables	(3,391)	1,972	1,412
Increase (decrease) in accrued compensation and benefits	421	4,444	(426)
Increase in income taxes payable	4,608	3,684	4,470
Increase (decrease) in accrued expenses and other accounts payable	(832)	3,075	3,940
Increase (decrease) in accrued severance pay, net	152	125	(7)
Other	21	(6)	—
Net cash provided by operating activities	27,393	34,492	34,275
Cash flows from investing activities:			
Purchase of held-to-maturity marketable securities	(129,899)	(191,882)	(144,269)
Proceeds from maturity of held-to-maturity marketable securities	108,246	146,395	156,474
Purchase of property and equipment	(1,759)	(3,158)	(1,924)
Proceeds from sale of property and equipment	—	72	53
Proceeds from realization of available for sale equity securities of traded companies	55,456	508	1,504
Payment for acquisition of Bermai Inc. assets	(5,128)	—	—
Purchase of available-for-sale marketable securities	—	—	(2,000)
Payment for acquisition of Teleman Multimedia Inc. assets	(1,450)	(2,325)	—
Cash received from (contributed to) discontinued operations	—	4,737	(6,463)
Net cash provided by (used in) investing activities	25,467	(45,653)	3,375

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

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DSP GROUP, INC. AND ITS SUBSIDIARIES

CONSOLIDATED STATEMENTS OF CASH FLOWS
U.S. dollars in thousands

	Year ended December 31,		
	2004	2003	2002
Cash flows from financing activities:			
Issuance of Common Stock and treasury stock upon exercise of stock options and upon purchase of ESPP	14,127	24,211	3,877
Purchase of treasury stock	(31,697)	(16,157)	—
Dividend related to the separation of Ceva	—	—	(40,754)
Net cash provided by (used in) financing activities	(17,570)	8,054	(36,877)
Increase (decrease) in cash and cash equivalents	35,290	(3,107)	773
Cash and cash equivalents at the beginning of the year	36,812	39,919	39,146
Cash and cash equivalents at the end of the year	$ 72,102	$ 36,812	$ 39,919
(a) Non-cash transactions:			
Non-cash contribution of prepaid offering expenses, property, equipment and inventory, net of assumed liabilities	$ —	$ —	$ 7,674
Purchase of property and equipment	$ —	$ 2,504	$ —
Supplemental disclosures of cash flows activities:			
Cash paid during the year for:			
Taxes on income	$ 17,149	$ 1,202	$ 2,462

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

DSP GROUP, INC. AND ITS SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(the presentation of the numbers in these consolidated notes is in thousands except for share and per share amounts)

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) environment. 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 five 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 Limited ("DSP Korea"), a Korean corporation, incorporated in 2003 and primarily engaged in the design, research and development of video applications, and (5) DSPG Edinburgh Limited ("DSP Scotland"), a Scottish corporation, primarily engaged in development and marketing of DECT based telephony solutions.

Acquisition of Bermai Inc. assets

During October 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 US 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.

The assets purchased by the Company consisted of property and equipment and intangible assets such as technology and patents used by Bermai in the conduct of its development activities. Bermai was a development stage company and therefore the acquisition does not qualify under EITF 98-3 for business combination accounting and as such the transaction was accounted for as an asset acquisition. The amount of consideration paid was determined based upon arms-length negotiations between the Company, on the one hand, and the liquidator of Bermai, on the other hand.

Based upon an independent valuation of tangible and intangible assets acquired, the Company has allocated the total cost of the acquisition of Bermai's assets as follows:

Tangible assets acquired	$ 322
Intangible assets:	
In process research and development	2,682
Patents	2,124
	4,806
Total	$ 5,128

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The value assigned to intangible assets was determined as follows:

1. The estimated fair value of the acquired in-process research and development technology that had not yet reached technological feasibility and had no alternative future use amounted to $2,682. Technological feasibility or commercial viability of these projects was established on the acquisition date. Accordingly, these amounts were immediately expensed in the Company's consolidated statement of operations in accordance with Financial Accounting Standards Board ("FASB") Interpretation No. 4, "Applicability of FASB Statement No. 2 to Business Combinations Accounted for by the Purchase Method." The value of in-process research and development was determined based on discounted cash flows approach that is a form of the income approach)i.e. focuses on the income or cash flow producing capability of the technology in question).

2. The value assigned to the patents amounted to $2,124, which will be amortized over a period of 4 years, and was determined based on "relief from royalty" approach that is a form of the income approach. The amount amortized during 2004 was $103.

Acquisition of Teleman Multimedia Inc.

During the second quarter of 2003, the Company entered into an asset purchase agreement with DSP Group Israel, and Teleman Multimedia Inc. ("Teleman"), a Delaware corporation, pursuant to which DSP Group Israel acquired substantially all of the assets of Teleman. Teleman, founded in 1998, has developed an advanced silicon platform for video compression and decompression designed to interface with image sensors and panel displays. The Teleman silicon platform supports compression standards such as MPEG4, JPEG and H263.

The assets purchased by DSP Group Israel consisted of property and equipment, and other assets (including intangible assets such as workforce and intellectual property) used by Teleman in the conduct of its business. The consideration for the assets purchased from Teleman consisted of cash in an aggregate amount of $5,000 and transaction expenses in the amount of approximately $250. $2,100 of the consideration was paid on May 16, 2003, the closing date of the acquisition, $1,450 on May 16, 2004, and the remaining consideration of $1,450 is to be paid on May 16, 2005. The May 16, 2005 installment was recorded at the fair value of $1,443. The amount of consideration was determined based upon arms-length negotiations between the Company, on the one hand, and Teleman and Teleman's shareholders, on the other hand. In addition, the Company hired 10 engineers that were previously employed by Teleman.

Disposition of assets and combination with Parthus

On November 1, 2002, the Company contributed its DSP cores licensing business (the "Separation") to Ceva, Inc., one of its then wholly-owned subsidiaries ("Ceva"). Immediately thereafter, Ceva effected a combination (the "Combination") with Parthus Technologies PLC ("Parthus").

Under the terms of the Separation, the Company transferred the assets and liabilities of its DSP cores licensing business to Ceva in exchange for Ceva common stock. The Company immediately thereafter distributed all of the Ceva common stock it held to the Company's stockholders of record on October 31, 2002. Ceva then effected the Combination whereby Ceva combined with Parthus and issued Ceva common stock to the former Parthus shareholders pursuant to a scheme of arrangement. After the Combination, the combined company was renamed ParthusCeva, Inc. and subsequently changed its name to Ceva Inc. (for purposes of discussion in these notes to the consolidated financial statements, the combined company will continue to be referred to as "ParthusCeva"). ParthusCeva's common stock is quoted on the NASDAQ National Market and listed on the London Stock Exchange. As part of the transaction, the Company contributed to Ceva cash in the amount of

DSP GROUP, INC. AND ITS SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

$40,000, property, equipment, inventory and paid transaction costs in the amount of $7,674 and paid $754 as a tax payment upon the Separation. Parthus also made a $60,000 capital repayment to its shareholders immediately prior to the Combination. The Company received private letter rulings from the U.S. Internal Revenue Service to the effect that, among other things, the Separation was a tax-free transaction to the Company's stockholders under Section 355 of the U.S. Internal Revenue Code of 1986, as amended, for federal income tax purposes, except with respect to cash distributed in lieu of fractional shares to the Company's stockholders.

At the effective time of the Separation, each stockholder of record of the Company on October 31, 2002 (the "Distribution Record Date") received one share of ParthusCeva's common stock for every three shares of the Company's common stock (the "Common Stock") held by such stockholder on the record date (the "Distribution"). Fractional shares were not issued. Instead, fractional interests were aggregated and sold on the open market on the first day after the closing of the transaction, and cash in lieu of fractional shares was distributed ratably to the Company's stockholders who would otherwise have received a fractional interest in ParthusCeva's common stock. The Distribution was made to the Company's stockholders without payment of any consideration or the exchange of any shares by the Company's stockholders. At the effective time of the Combination, in exchange for Parthus ordinary shares which were cancelled as part of the scheme of arrangement, each shareholder of Parthus received 0.015141 of a share of ParthusCeva's common stock for each ordinary share of Parthus held by such shareholder (0.15141 shares per Parthus ADS) on October 31, 2002, the record date for the Combination, and cash in lieu of fractional shares.

As a result of the Separation and Combination, the Company distributed 9,041,851 shares of ParthusCeva's common stock to its stockholders (representing 50.1% of ParthusCeva after the transaction), and ParthusCeva issued 8,998,887 shares of its common stock to the former Parthus shareholders (representing 49.9% of ParthusCeva after the transaction) and assumed options to purchase approximately 1,644,435 shares of ParthusCeva's common stock based on Parthus options outstanding as of June 30, 2002. The relative ratio of shares distributed to the Company's stockholders and shares issued to the former Parthus shareholders, as well as the other material terms of the transactions, were determined pursuant to arms-length negotiations between the parties. Options to purchase Common Stock outstanding under the Company's stock option plans were also adjusted as of November 1, 2002, to reflect the distribution of assets to ParthusCeva in connection with the Separation. (See also Note 8).

In accounting for the Separation, the Company recorded in the consolidated statements of changes in stockholders' equity an amount of $48,428 as a deemed dividend in-kind to its stockholders, representing the carrying amount of its investment in Ceva. This dividend in-kind consisted of the cash contribution to Ceva in the amount of $40,000, a tax payment of $754 recorded in the consolidated statements of cash flow and a non-cash contributions of prepaid offering expenses, inventory and property and equipment, net of assumed liabilities, in the amount of $7,674.

The Company's 2002 financial statements, which include the licensing and technology business of Ceva, have been reclassified to present the assets, liabilities, results of operations and cash flows of Ceva as discontinued operations in accordance with Statement of Financial Accounting Standard No. 144 "Accounting for the Impairment or Disposal of Long-Lived Assets" ("SFAS No. 144"). (See also Note 13).

The discontinued operations presented for prior years included the allocation of certain of the Company's corporate headquarters' assets, liabilities and expenses related to the licensing and technology business of Ceva.

The income from discontinued operations included the costs directly attributable to the licensing and technology business of Ceva including charges for shared facilities, functions and services used by the licensing

business. Certain costs and expenses have been allocated based on management's estimate of the cost of services provided to the licensing and technology business. Such costs included research and development costs and sales expenses.

During the year ended December 31, 2003, the Company collected approximately $4,737 from customers of the DSP cores licensing business that it transferred to Ceva in 2002. This amount was included under cash received from discontinued operations in the Company's consolidated statements of cash flows.

VoicePump, Inc.

VoicePump, Inc. ("VoicePump"), a wholly-owned subsidiary of the Company, is 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).

The Company's investment in VoicePump included the excess of its purchase price over the net assets acquired which was attributed to goodwill. Under Statement of Financial Accounting Standard No. 142, "Goodwill and Other Intangible Assets" ("SFAS No. 142"), goodwill acquired in a business combination is not amortized. As a result, the Company ceased amortization of the goodwill related to the acquisition of VoicePump after December 31, 2001. The book value of the goodwill was approximately $5,800 as of that date.

The Company assesses the carrying value of goodwill in accordance with SFAS No. 142, under which goodwill is tested for impairment at least annually or between annual tests in certain circumstances, and written down when impaired. Goodwill attributable to the Company's reporting unit as defined under SFAS No. 142 was tested for impairment by comparing its fair value with its carrying value.

During the second quarter of 2004, the Company decided to stop developing products targeted at the VoP 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 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 is included in the Company's operating expenses for year ended December 31, 2004 under "Impairment of goodwill".

Due to the reorganization of its activities during December 2004, the Company decided to combine the operations of VoicePump within the consolidated corporate structure and transferred all the remaining operations and sales of VoIP gateway products to the Company and the technology related to future VoIP telephony products to DSP Group Israel. As a result, VoicePump Inc. ceased to operate as a company and its assets were transferred to the Company and DSP Group Israel.

Concentration of other risks

All of the Company's integrated circuit products are manufactured by independent foundries. While these foundries have been able to adequately meet the demands of the Company's increasing business, the Company is

DSP GROUP, INC. AND ITS SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

and will continue to be dependent upon these foundries to achieve acceptable manufacturing yields, quality levels and costs, and to allocate to the Company sufficient portion of foundry capacity to meet the Company's needs in a timely manner. Revenues could be materially and adversely affected should any of these foundries 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 (see Note 9). 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.

NOTE 2: SIGNIFICANT ACCOUNTING POLICIES

The consolidated financial statements have been prepared in accordance with US Generally Accepted Accounting Principles. ("US GAAP").

Use of estimates

The preparation of the financial statements in conformity with US 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.

Financial statements in U.S. dollars

All of the revenues of the Company and its subsidiaries are generated in US 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 primary currency of the 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.

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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 equivalents

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

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, "Accounting for Certain Investments in Debt and Equity Securities" ("SFAS No. 115"). Management determines the appropriate classification of its investments in debt and equity securities at the time of purchase and reevaluates such determinations at each balance sheet date.

At December 31, 2004 and 2003, the Company classified its investment in marketable securities as held-to-maturity and available-for-sale.

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.

Investment in equity securities of traded companies is classified as available-for-sale and is stated at fair value, with unrealized gains and losses reported in accumulated other comprehensive income (loss), a separate component of stockholders' equity, net of taxes. Realized gains and losses on sales of investments, as determined on a specific identification basis, are included in the consolidated statements of income.

According to Staff Accounting Bulletin No. 59 "Accounting for Non-current Marketable Equity Securities" ("SAB No. 59"), management is required to evaluate each quarter whether a security's decline in value is other than temporary. In 2002, the Company recognized an other than temporary decline in the carrying value of its available-for-sale securities in the amount of $10,229, which was included in the statements of income as of December 31, 2002 as impairment of available-for-sale marketable securities.

Fair value of financial instruments

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

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. The carrying value of held-to-maturity marketable securities is based on amortized cost. The fair value of held-to-maturity securities and available-for-sale marketable securities is based on quoted market price (see Notes 3 and 6).

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.

DSP GROUP, INC. AND ITS SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

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 made when required to write-down inventory to its market value.

Cost is determined as follows:

Work in progress—at the cost of raw material and manufacturing.

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

Property and equipment

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

	%
Computers and peripheral equipment	20-33
Office furniture and equipment	7-10
Motor vehicles	15
Leasehold improvements	Over the terms of the lease

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. Patents and work force are amortized over a period of 4 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, 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, 2002, 2003 and 2004, no impairment losses have been identified.

Goodwill

The Company's investment in VoicePump included the excess of its purchase price over the net assets acquired which was attributed to goodwill. Under SFAS No. 142, goodwill acquired in a business combination is not amortized. As a result, the Company ceased amortization of the goodwill related to the acquisition of VoicePump after December 31, 2001. The book value of the goodwill was approximately $5,800 as of that date.

During 2002 and 2003, 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.

DSP GROUP, INC. AND ITS SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

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 Israeli 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.

Severance expenses for the years ended December 31, 2004, 2003 and 2002, were approximately $285, $882 and $392, respectively.

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, which is generally when the goods are shipped.

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 probable, and no significant obligations remain.

The terms of Company’s arrangements with customers is “FOB shipping point.” The Company considers that a customer has taken title and assumed the risks and rewards of ownership of the products when the products are shipped.

The Company does not grant any rights of return.

Research and development costs

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

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 approximately 3,963,202, 1,495,279 and 3,825,000 shares of Common Stock for the years ended December 31, 2004, 2003 and 2002, 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, trade receivables, long-term lease deposits, and held-to-maturity and available-for-sale marketable securities.

The majority of cash and cash equivalents of the Company and its subsidiaries is invested in U.S. dollar deposits in 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 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, 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, other collateral or guarantee fees. The Company covers most of its customers’ receivables through credit insurance.

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.

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 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

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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 Shekel (“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 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 December 31, 2004, the Company recorded Accumulated Other Comprehensive Income in the amount of $65 from its put options and forward contracts with respect to anticipated payroll and rent payments expected in 2005. Such amounts will be recorded into earnings in 2005.

Accounting for stock-based compensation

The Company accounts for stock-based compensation in accordance with the provisions of Accounting Principles Board Opinion No. 25, “Accounting for Stock Issued to Employees” (“APB No. 25”) and FASB interpretation No. 44, “Accounting for Certain Transactions Involving Stock Compensation” (“FIN No. 44”) in accounting for its employee stock options. Under APB No. 25, when the exercise price of an employee’s options equals or is higher than the market price of the underlying Common Stock on the date of grant, no compensation expense is recognized.

The Company has adopted the disclosure provisions of Statement of Financial Accounting Standard No. 148, “Accounting for Stock-Based Compensation—Transition and Disclosure”, which amended certain provisions of Statement of Financial Accounting Standard No. 123 “Accounting for Stock-Based Compensation” (“SFAS No. 123”). The Company continues to apply the provisions of APB No. 25 in accounting for stock-based compensation.

Pro forma information regarding the Company’s net income and net earnings per share is required by SFAS No. 123 and has been determined as if the Company had accounted for its employee stock options under the fair value method prescribed by SFAS No. 123.

The fair value of these options is amortized over their vesting period and estimated on the date of grant using a Black-Scholes option pricing model with the following weighted average assumptions: risk-free interest rates of 3.23%, 2.37% and 3.7% for 2004, 2003 and 2002, respectively; a dividend yield of 0.0% for each of those years; a volatility factor of the expected market price of Common Stock of 0.38 for 2004, 0.44 for 2003 and 0.81 for 2002; and a weighted-average expected life of the option of 2.9 years for 2004, 2003 and 2002.

	Year ended December 31,		
	Weighted average fair value of options grants		
	2004	2003	2002
Exercise price equals market price on date of grants	$ 6.73	$ 5.58	$ 5.49

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DSP GROUP, INC. AND ITS SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

The following table illustrates the effect on net income and net earnings per share, assuming that the Company had applied the fair value recognition provision of SFAS 123 on its stock-based employee compensation:

	Year ended December 31,		
	2004	2003	2002
Net income, as reported	$ 51,094	$ 25,355	$ 15,142
Deduct—stock-based compensation expense determined under fair value method for all awards, net of related tax effects	10,570	9,338	12,712
Pro forma net income	$ 40,524	$ 16,017	$ 2,430
Net earnings per share:			
Basic, as reported	$ 1.79	$ 0.91	$ 0.56
Basic, pro forma	$ 1.42	$ 0.57	$ 0.09
Diluted, as reported	$ 1.70	$ 0.86	$ 0.54
Diluted, pro forma	$ 1.35	$ 0.54	$ 0.09
Net income from continuing operations, as reported	$ 51,094	$ 25,355	$ 12,672
Deduct—stock based compensation expenses related to continuing operations determined under fair value method for all awards, net of related tax effect	10,308	8,677	11,145
Pro forma net income from continuing operations	$ 40,786	$ 16,678	$ 1,527
Net earnings per share from continuing operations:			
Basic, as reported	$ 1.79	$ 0.91	$ 0.47
Basic, pro forma	$ 1.43	$ 0.59	$ 0.06
Diluted, as reported	$ 1.70	$ 0.86	$ 0.45
Diluted, pro forma	$ 1.36	$ 0.56	$ 0.05

Impact of recently issued accounting standards

In March 2004, the Financial Accounting Standards Board ("FASB") approved the consensus reached on the 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"). The objective of this Issue is to provide guidance for identifying impaired investments. EITF 03-1 also provides new disclosure requirements for investments that are deemed to be temporarily impaired. In September 2004, the FASB issued FASB Staff Position ("FSP") FSP EITF 03-1-1, "Effective Date of Paragraphs 10-20 of EITF Issue No. 03-1," which defers the effective date for the measurement and recognition guidance contained in paragraphs 10-20 of EITF 03-1 pending the development of further guidance. The Company will continue to monitor these developments concerning this Issue and are currently unable to determine the impact of EITF 03-1 on its financial position or results of operations.

On December 16, 2004, the FASB issued Statement No. 123R (revised 2004 Share-Based Payment ("Statement 123R"), which is a revision of SFAS No. 123. Generally, the approach in Statement 123(R) is similar to the approach described in SFAS No. 123. However, SFAS No. 123 permitted, but did not require, share-based payments to employees to be recognized in income based on their fair values while Statement

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123(R) requires all share-based payments to employees to be recognized in income based on their fair values. Statement 123R also revises, clarifies and expands guidance in several areas, including measuring fair value, classifying an award as equity or as a liability and attributing compensation cost to reporting periods. The new standard will be effective for the Company in the first interim period beginning after June 15, 2005. The Company is currently evaluating the impact from this standard on its results of operations and financial position.

NOTE 3: MARKETABLE SECURITIES

The following is a summary of held-to-maturity securities at December 31, 2004 and 2003:

	Amortized cost		Unrealized gains (losses), net		Estimated fair value	
	2004	2003	2004	2003	2004	2003
US Government obligations and political subdivisions	$ 131,999	$ 99,244	$ (1,582)	$ (259)	$ 130,417	$ 98,985
Corporate obligations	123,856	137,313	(380)	2,012	123,476	139,325
	$ 255,855	$ 236,557	$ (1,962)	$ 1,753	$ 253,893	$ 238,310

The amortized cost of held-to-maturity debt securities at December 31, 2004, by contractual maturities, is shown below:

	Amortized cost	Unrealized gains (losses), net	Estimated fair value
	2004	2004	2004
Due in one year or less	$ 60,184	$ 186	$ 60,370
Due after one year to five years	195,671	(2,148)	193,523
	$ 255,855	$ (1,962)	$ 253,893

The unrealized losses in the Company's investments in held-to-maturity marketable securities were mainly 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 bonds were not considered to be other than temporarily impaired at December 31, 2004.

NOTE 4: INVENTORIES

Inventories are composed of the following:

	December 31,	
	2004	2003
Work-in-progress	$ 4,571	$ 2,593
Finished products	4,898	5,873
	$ 9,469	$ 8,466

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NOTE 5: PROPERTY AND EQUIPMENT

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

	December 31,	
	2004	2003
Cost:		
Computers and peripheral equipment	$ 24,965	$ 22,896
Office furniture and equipment	954	893
Motor vehicles	154	369
Leasehold improvements	1,957	1,791
	28,030	25,949
Less—accumulated depreciation	21,347	18,841
Depreciated cost	$ 6,683	$ 7,108

NOTE 6: INVESTMENTS IN EQUITY SECURITIES OF TRADED COMPANIES

The following is a summary of investments in equity securities of traded companies as of December 31, 2004 and 2003:

	Cost		Unrealized gains		Estimated fair value	
	2004	2003	2004	2003	2004	2003
AudioCodes Ltd.(1)	$ —	$ 10,726	$ —	$ 35,739	$ —	$ 46,465
Tomen Corporation(2)	—	281	—	392	—	673
	$ —	$ 11,007	$ —	$ 36,131	$ —	$ 47,138

(1) 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.

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.

On June 30, 2002, an evaluation by the Company's management indicated that the decline in value of AudioCodes' ordinary shares was other than temporary in accordance with SAB No. 59. As a result, the Company recognized a loss in its investment in AudioCodes in the amount of $9,795, which was recorded as "impairment of available-for-sale marketable securities" in the Company's consolidated statements of income for the year 2002.

As of December 31, 2003, the Company owned approximately 4,500,000 shares of AudioCodes' ordinary shares.

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The consolidated balance sheet as of December 31, 2003 included an unrealized gain on available-for-sale marketable securities of $22,516, net of unrealized tax expenses of $15,232, in the investment in AudioCodes.

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 shares 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 shares 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.

(2) Tomen Corporation:

In September 2000, the Company invested approximately $485 (50.0 million Yen) 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 accounts for its investment in Tomen in accordance with SFAS No. 115 as available-for-sale marketable securities.

On December 31, 2002, an evaluation by the Company's management indicated that the decline in value of Tomen stock was other than temporary in accordance with SAB No. 59. As a result, the Company recognized a loss in its investment in Tomen in the amount of $203, which was recorded as "impairment of available-for-sale marketable securities" in the consolidated statements of income for the year 2002.

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

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

	Year ended December 31,	
	2004	2003
Cost:		
Patents	$ 4,009	$ 1,885
Workforce	570	570
Total	4,579	2,455
Less—accumulated amortization:		
Patents	866	291
Workforce	231	88
	1,097	379
Amortized cost	$ 3,482	$ 2,076

Intangible assets represent the acquisition of patents and workforce acquired, upon the purchase of substantially all of the assets of Bermai in 2004 and the acquisition of Teleman in 2003. (See Note 1).

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Amortization expenses amounted to $718 for the year ended December 31, 2004.

Estimated amortization expenses for the years ended:

Year ended December 31,	
2005	$ 1,145
2006	1,145
2007	765
2008	427
	$ 3,482

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 (the "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.

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

As part of the Separation described in Note 1, the Company distributed to its stockholders shares of Ceva's common stock as a dividend in-kind amounting to $48,428.

At December 31, 2004, the Company had retained earnings of $157,723. 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 July 2003, the Company's Board of Directors approved a share repurchase program for up to 2.5 million shares of Common Stock from time to time on the open market or in privately negotiated transactions. In October 2004, the Board of Directors authorized an additional 2.5 million shares of Common Stock for repurchase under the share repurchase program, increasing the total shares authorized to be repurchased to 9.0 million shares. In

DSP GROUP, INC. AND ITS SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

2004 and 2003, the Company repurchased 1,577,000 and 746,000 shares, respectively, of the Common Stock at an average purchase price of $20.09 and $21.66 per share, respectively, for an aggregate purchase price of $31,697 and $16,157, respectively. As of December 31, 2004, the balance of the share repurchase program is 3,697,000 shares of Common Stock authorized.

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 case the repurchasing cost is lower than the issuance price, the Company credits the difference to additional paid-in capital.

In 2004, 2003 and 2002, the Company issued 145,000, 693,000 and 363,000 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:

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 1,130,875 shares of Common Stock at an exercise price equal to the fair market value of the Common Stock on the date of grant. As of December 31, 2004, no additional shares of Common Stock are authorized for grant under the Directors' Plan. 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 ten years. 25% of the shares pursuant to the First Option are exercisable after the first year (one-third after the first year for options granted after May

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1996) and thereafter the shares are exercisable in quarterly installments over the ensuing three years (one-third at the end of each twelve-month period for options granted after May 1996). Each Subsequent Option becomes exercisable in full on the fourth anniversary from the date of grant (one-third at the end of each twelve-month period from the date of grant for options granted after May 1996). Each Committee Option becomes exercisable (one-third at the end of each twelve-month period from the date of grant after May 1996).

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 5,301,881 shares of Common Stock.

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 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, unless it is terminated by the Board of Directors prior to that date. 1,513,663 shares of Common Stock are currently reserved for issuance under the 2001 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 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 following the year in which the options were granted or the options are vested based on a vesting schedule determined by a committee appointed by the Company's Board of Directors. 2,803,416 shares of Common Stock were reserved for issuance as of December 31, 2004 under this plan.

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 700,000 shares of Common Stock for issuance under the ESPP. The ESPP

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provides that substantially all employees may purchase stock at 85% of its fair market value on specified dates via payroll deductions. There were approximately 70,000, 52,000 and 49,000 shares issued at a weighted average exercise price of $13.61 $12.40 and $16.98 under the ESPP in 2004, 2003 and 2002, respectively.

Options Granted to New Employees

In order to induce former Bermai employees to join the Company, such employees were granted employment inducement stock options to purchase a total of 239,000 shares of Common Stock. These option grants have an exercise price of $22.67 per share and will vest over a period of four years.

Stock reserved for future issuance

Shares of Common Stock available for future issuance outstanding as of December 31, 2004, are as follows:

	In thousands
Employee stock purchase plan	140
Stock options	649
Undesignated Preferred Stock	5,000
	5,789

The following is a summary of the Company's stock options granted among the various plans:

	Year ended December 31,					
	2004		2003		2002	
	Amount of options In thousands	Weighted average exercise price $	Amount of options In thousands	Weighted average exercise price $	Amount of options In thousands	Weighted average exercise price $
Options outstanding at beginning of year	7,014	20.04	6,308	17.03	5,725	21.91
Changes during the year:						
Granted	1,569	23.41	2,482*	21.68	1,376	19.22
Exercised	(760)	15.81	(1,676)	11.19	(251)	9.42
Forfeited and cancelled	(368)	24.64	(100)*	18.77	(514)	24.44
Restructuring adjustments(1):						
Old exercise price	—	—	—	—	(6,338)	21.52
New exercise price	—	—	—	—	6,338	17.01
Additional grants	—	—	—	—	1,116	17.01
Separation of Ceva's employees' options	—	—	—	—	(1,144)	17.41
Options outstanding at end of year	7,455	20.95	7,014	20.04	6,308	17.03
Options exercisable at end of year	3,873	21.03	2,997	21.02	3,147	17.31

* Excluding options to purchase 876,000 shares of Common Stock that were cancelled and re-granted pursuant to Israeli tax reform.

DSP GROUP, INC. AND ITS SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

A summary of activity under the options plans related to Ceva employees post the Separation date:

	Year ended December 31, 2004		Year ended December 31, 2003	
	Number of options In thousands	Weighted average exercise price $	Number of options In thousands	Weighted average exercise price $
Options outstanding at the beginning of the year	657	21.03	1,056	17.96
Changes during the year:				
Exercised	(86)	13.53	(386)	12.47
Forfeited and cancelled	(25)	31.06	(13)	25.79
Options outstanding at end of year	546	21.75	657	21.03
Options exercisable at end of year	476	21.87	503	20.94

In connection with the Separation, all options to purchase Common Stock held by individuals who continued to work for the Company and its subsidiaries and by individuals who transferred to ParthusCeva, that were outstanding on the date of the Separation and that remained unexercised as of this date, were adjusted as follows:

For employees who continued to work for the Company—The exercise price and the number of shares subject to the Company's options were adjusted to reflect the theoretical reduction in value of the Common Stock as a result of the Separation, which was calculated based on the theoretical fair market value of the Company and ParthusCeva post the Separation.

For employees who transferred to ParthusCeva—The exercise price subject to the Company's options were adjusted to reflect the theoretical reduction in value of the Common Stock as a result of the Separation, which was calculated based on the theoretical fair market value of the Company and ParthusCeva post the Separation.

The Company has accounted for this transaction under FIN No. 44. According to FIN No. 44, at the time of an equity restructuring transaction, the exercise price may be reduced and the number of shares under the award increased, to offset the decrease in the per-share price of the stock underlying the award. There was no accounting consequence for changes made to the exercise price and the number of shares of an outstanding fixed award as a result of an equity restructuring as both of the following criteria were met:

The aggregate intrinsic value of the award immediately after the change is not greater than the aggregate intrinsic value of the award immediately prior to the change.

The ratio of the exercise price per share to the market value per share is not reduced.

The Company granted options to purchase an additional 1,116,000 shares of Common Stock to its continuing employees as part of the adjustment described above. The weighted average exercise price of all the outstanding options was reduced from $21.52 to $17.01 (21%).

DSP GROUP, INC. AND ITS SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

The options outstanding as of December 31, 2004, have been separated into ranges of exercise price as follows:

	Options outstanding			Options exercisable		
Range of exercise price	Outstanding In thousands	Remaining contractual life (years)	Weighted average exercise price	Exercisable In thousands	Remaining contractual life (years)	Weighted average exercise price
$7.76 – $10.87	245	1.15	$ 7.61	244	1.14	$ 7.59
$11.26 – $16.81	2,080	4.33	$ 14.25	1,261	3.99	$ 14.27
$16.89 – $23.29	2,633	5.05	$ 19.91	1,099	3.69	$ 18.86
$23.35 – $34.24	2,798	4.54	$ 26.77	1,501	3.03	$ 28.31
$35.17 – $42.73	245	2.44	$ 36.13	244	2.44	$ 36.13
	8,001		$ 20.96	4,349		$ 21.12

NOTE 9: MAJOR CUSTOMERS AND GEOGRAPHIC INFORMATION

In prior years, the Company had two reportable segments and thus, the financial statements in prior years included information regarding both reportable segments and geographic areas. After the Separation, the Company has one reportable segment and thus, the financial statements include information regarding geographic areas only.

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

	Year ended December 31,		
	2004	2003	2002
Revenue distribution:			
United States	$ 1,238	$ 1,302	$ 711
Japan	119,052	119,355	99,795
Europe	1,831	3,063	4,819
Hong Kong	27,700	21,624	11,264
Other	7,690	7,531	8,569
	$ 157,511	$ 152,875	$ 125,158

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

	December 31,		
	2004	2003	2002
Long-lived assets:			
United States	$ 4,270	$ 6,321	$ 6,724
Israel	5,563	6,215	3,657
Other	1,832	2,452	113
	$ 11,665	$ 14,988	$ 10,494

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The following is a summary of revenues from major customers:

	Year ended December 31,		
	2004	2003	2002
		%	
End customer A*	51%	58%	66%
End customer B*	20%	18%	12%
End customer C	17%	13%	—

* 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 noncancelable operating leases. The Company has significant leased facilities in Herzelia Pituach, Israel and in California. The lease agreement for the Israeli facilities is effective until November 2008. The Company has various agreements for its facilities in the U.S. terminating in 2005-2009. In November 2004, DSP Japan entered into a new facility in Tokyo, Japan. This new lease is effective until October 2006. The Company's subsidiaries in Korea and Scotland have lease agreements for their facilities that terminate in 2005. The Company has operating lease agreements for its vehicles, which terminate in 2005 to 2007.

At December 31, 2004, the Company is required to make the following minimum lease payments under non-cancelable operating leases for its vehicles and facilities:

Year ended December 31,	
2005	$ 2,731
2006	2,378
2007	1,348
2008	948
2009	199
	$ 7,604

Claims

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.

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 may from time to time be notified of claims that it 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. During 2002, the Company created 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.

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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,		
	2004	2003	2002
Domestic taxes:			
Federal taxes:			
Current	$ 15,637	$ 2,259	$ 1,451
Deferred	(2,929)	(82)	(3,549)
	12,708	2,177	(2,098)
State taxes:			
Current	1,159	33	357
Deferred	(132)	(10)	(141)
	1,027	23	216
Foreign taxes:			
Current	7,679	3,447	2,976
Deferred	68	(272)	(200)
	7,747	3,175	2,776
Taxes on income	$ 21,482	$ 5,375	$ 894

The tax benefits associated with the exercise of non qualified stock options reduced taxes currently payable by $565 in 2004, $685 in 2003 and $324 in 2002. Such benefits were credited to additional paid-in capital.

b. Income before taxes is comprised as follows:

	Year ended December 31,		
	2004	2003	2002
Domestic	$ 47,461	$ 5,155	$ (8,249)
Foreign	25,115	25,575	21,815
	$ 72,576	$ 30,730	$ 13,566

c. The cumulative amount of the undistributed earnings of DSP Group Israel, which is intended to be permanently reinvested and for which U.S. income taxes have not been paid, totaled approximately $37,292 at December 31, 2004. Subsequent to the balance sheet date, the Board of Directors of DSP Group Israel approved the capitalization of such amount.

d. 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,		
	2004	2003	2002
Income before taxes on income	$ 72,576	$ 30,730	$ 13,566
Theoretical tax at US statutory tax rate (35%)	$ 25,402	$ 10,756	$ 4,748
State taxes, net of federal benefit	667	16	235
Goodwill impairment	1,506	—	—
Foreign income taxed at rates other than U.S. rate	(5,514)	(5,785)	(4,859)
Other individually immaterial items	(579)	388	770
	$ 21,482	$ 5,375	$ 894

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e. 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,	
	2004	2003
Deferred tax assets (short-term):		
Tax credit carry forward	$ —	$ 43
Reserves and accruals	1,168	1,220
Other	—	63
Total deferred tax assets and long-term tax assets	$ 1,168	$ 1,326
Deferred tax assets (liabilities), net (long-term):		
Investment in AudioCodes	$ —	$ (15,232)
Intangible assets	1,208	272
Other	202	368
Total deferred tax assets (liabilities), net	1,410	(14,592)
Total net deferred tax assets (liabilities)	$ 2,578	$ (13,266)

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 on a cumulative total of $37 million of the undistributed earnings of DSP Group Israel. The Company intends to invest these earnings indefinitely in operations outside the U.S.

f. Tax benefits under the Law for the Encouragement of Capital Investments, 1959 (the “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 “alternative plan benefits,” which is a waiver of grants in return for 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 percentage of foreign ownership) for an additional period of eight or six years, respectively. The tax benefits under these investment plans are scheduled to gradually expire starting in 2005 through 2017.

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 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 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 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 rate 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, 2004, DSP Group Israel has 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 in 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 rate of 35% 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, 2004, approximately $8,291 were derived from tax exempt profits earned by DSP Group Israel's "Approved Enterprises". The Company has determined that such tax-exempt income will not be distributed as dividends. Accordingly, no deferred income taxes have been provided on income attributable to DSP Group Israel's "Approved Enterprise."

If the retained tax-exempt income is distributed in a manner other than in 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 $829 would be incurred as of December 31, 2004.

Income from DSP Group Israel from sources other than the "Approved Enterprise" during the benefit period will be subject to tax at the standard corporate tax rate in Israel of 35%.

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.

g. 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.

h. Separation of Ceva, Ltd.:

DSP Group Israel obtained a tax ruling for the tax-exempt treatment of the Separation pursuant to section 105A(a) of the Israeli Income Tax Ordinance ("section 105"). Under section 105 and according to the ruling, the majority of the assets that remain in DSP Group Israel cannot be sold for a two-year period from the date of Separation and is subject to other requirements as determined by law.

As part of the Separation, certain fractions of the approved plans were assigned to Ceva in accordance with the relevant turnover that derives from each activity.

Income from "Alternative plan benefits" is subject to corporate tax income upon distribution to the stockholders. Prior to the Separation, and according to the Income Tax Authority ruling, DSP Group Israel has capitalized all accrued revenues that were accrued until October 30, 2002.

See Note 1 in respect of the ruling obtained from U.S. Internal Revenue Service.

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DSP GROUP, INC. AND ITS SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

i. Amendment 132 to the Israeli Income Tax Ordinance:

In July 2002, Amendment 132 to the Israeli Income Tax Ordinance (the "2002 Amendment") was approved by the Israeli parliament and has been effective since January 1, 2003. The principal objectives of the 2002 Amendment were to broaden the categories of taxable income and to reduce the tax rates imposed on employment income.

There are no material implications of the 2002 Amendment applicable to the Company, except for certain modifications in the qualified taxation tracks of employee stock options. As a result, in 2003, the Company adopted an Israeli Appendix to the 1993, 1998 and 2001 plans, which complies with the Israeli tax reforms, and established the 2003 Plan.

j. Reduction in corporate tax rate:

On June 2004, the Israeli Parliament approved an amendment to the Income Tax Ordinance (No. 140 and Temporary Provision), which progressively reduces the corporate tax rate from 36% to 35% in 2004 and to a rate of 30% in 2007.

NOTE 12: NET EARNINGS PER SHARE

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

	Year ended December 31,		
	2004	**2003**	**2002**
Numerator:			
Income from continuing operations	$ 51,094	$ 25,355	$ 12,672
Income from discontinued operations of Ceva	$ —	$ —	$ 2,470
Net income	$ 51,094	$ 25,355	$ 15,142
Denominator:			
Weighted average number of shares of Common Stock outstanding during the year used to compute basic net earnings per share (in thousands)	27,959	27,912	27,070
Incremental shares attributable to exercise of outstanding options (assuming proceeds would be used to purchase treasury stock) (in thousands)	1,133	1,681	971
Weighted average number of shares of Common Stock used to compute diluted net earnings per share (in thousands)	29,092	29,593	28,041
Basic net earnings per share	$ 1.79	$ 0.91	$ 0.56
Diluted net earnings per share	$ 1.70	$ 0.86	$ 0.54
Basic earnings per share (continuing operations)	$ 1.79	$ 0.91	$ 0.47
Diluted earnings per share (continuing operations)	$ 1.70	$ 0.86	$ 0.45
Basic earnings per share (discontinued operations)	$ —	$ —	$ 0.09
Diluted earnings per share (discontinued operations)	$ —	$ —	$ 0.09

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DSP GROUP, INC. AND ITS SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

NOTE 13: DISCONTINUED OPERATIONS

Pursuant to the Combination Agreement entered into on April 4, 2002, the Company agreed to affect a combination of its DSP cores licensing business (which the Company transferred to Ceva) with the business of Parthus. The Separation and Combination was completed on November 1, 2002. This transaction was accounted for in accordance with Statements of Financial Accounting Standard No. 144 "Accounting for the Impairment or Disposal or Long Lived Assets". For more details about the Separation and Combination, see Note 1.

As a result of the Separation and Combination, the results of operations, including revenue, operating expenses, financial income and income taxes of the DSP cores licensing business for the year ended December 31, 2002, have been reclassified in the accompanying statements of income as discontinued operations.

As of the date of Separation, Ceva's trade receivable remained with the Company.

The results of operations of the DSP cores licensing business transferred to Ceva, which were reported separately as discontinued operations in the statement of income for the year ended December 31, 2002, are summarized as follows:

	Year ended December 31, 2002
Revenues	$ 14,122
Cost of revenues	1,058
Gross profit	13,064
Operating expenses:	
Research and development, net	5,208
Selling and marketing	2,436
General and administrative	2,608
Total operating expenses	10,252
Operating income	2,812
Disposal of assets and liabilities	393
Financial income, net	78
Income before taxes on income	3,283
Taxes on income	813
Net income from discontinued operations	$ 2,470
Net earnings per share for discontinued operations:	
Basic	$ 0.09
Diluted	$ 0.09