



Zone-IP Ltd.  
and its subsidiaries

(Formerly Ki-Bi Mobile Technologies Ltd.)

Consolidated  
Financial Statements

31 December 2006

# Consolidated Financial Statements

AS OF 31 DECEMBER 2006

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ALL NUMBERS IN THESE CONSOLIDATED FINANCIAL STATEMENTS  
ARE U.S. DOLLARS IN THOUSANDS  
(EXCEPT SHARE AND PER SHARE DATA)

## Chairman's Statement

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In the year ended 31 December 2006 the Company incurred a loss on continuing operations of \$5.4 million (2005: profit \$0.1 million) on turnover of \$6.6 million (2005: \$4.5 million). At that date, the Company had a cash portfolio of \$7 million.

The year ended 31 December 2006 was a disappointing year for the Company. In April 2006, the Company decided to discontinue the card operations (the Company's principal business at that time) but continued to support its existing customers. As a result of this decision, 17 employees including the chief executive officer and chief financial officer ceased employment with the Company.

On 13 July 2006, the Company acquired Emblaze V CON, a company providing video over-IP conferencing solutions to corporate customers. Under IFRS, the accounting treatment required that the transaction is treated as an acquisition by Emblaze V CON. Accordingly, the financial statements for the year ended 31 December 2006 reflect the trading results of Emblaze V CON for the full year and the results of Zone-IP and its subsidiaries for the "post-acquisition" period from 13 July 2006.

Emblaze V CON develops and manufactures a variety of video conferencing solutions that enable seamless communication and collaboration using all forms of interactive media. The company's award-winning technology ensures the highest audio and video performance for organizations worldwide. Emblaze V CON's meeting and collaboration solutions include desktop and group videoconferencing products, audio conferencing products, data conferencing products and management systems. The company markets its products and services through a network of reseller partners, OEMS and value-added resellers around the world. Emblaze V CON has world-wide headquarters in Israel and regional offices in Munich, Rome, London, New Jersey and Beijing.

In September 2006, the Company announced it had relieved Mr. Moshe Leder of his duties as chief executive of Emblaze V CON and that Mr. Tal Barnoach, a non-executive director of the Company, had agreed to take on temporary executive responsibilities pending the appointment of a new chief executive.

Mr Barnoach conducted a strategic review of the Company's operations and core technologies. Following the review, the Company appointed a new VP R&D and a new VP Sales & Marketing and a new strategy plan was put forth. An overall change took place to maintain focus on the Company's core business, strong execution, better visibility in the market and strengthened stronghold in emerging markets

As a result, Emblaze V CON is planning a number of new product launches and upgrades in our existing product line in the first half of the current financial year. Emblaze V CON intends to extend its range of products and service offering to customers and enhance the technology of existing products.

Emblaze V CON will endeavour to strengthen its leading position in Video over IP, focus on solution-based selling and enhance its relationships and partnerships with industry technology and service providers.

### **Current trading**

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Trading in the first quarter of the current financial year is in line with management's expectations, which were approved by the Board of directors in December 2006, following the strategic review.

### **Future prospects**

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The Directors expect that demand for communication tools using IP (Internet Protocol) standards will increase as corporations worldwide move to replace and converge their legacy analog systems into more advanced IP based products.

The Directors believe that the growing demand for visual communication solutions will enable Emblaze V CON to achieve higher sales in 2007.

**Dr. Hans Wagner**  
Chairman

## Board of Directors

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### **Dr Hans Wagner, Chairman**

Dr. Wagner (76) has been Chairman of the Company since its admission to AIM in May 2005. He has served as deputy chairman of M-Systems since November 2002. Since 2003 Dr. Wagner has been chairman of Bamboo Multicasting, an Israeli company in the area of Mobile Infrastructure-Media equipment and in April 2006 became chairman of Eyesquad GmbH, a German company in the area of optical improvement of cameras for mobile phones. Dr. Wagner was senior partner of Omega Partners Ltd., a telecommunications consultancy firm, of which he was a founder in 1977. Dr. Wagner also founded and serves as vice chairman of Ozone Ltd., a manufacturer of ozone generators founded in 1996, and was chairman and founder of Pelikon Ltd., a developer and manufacturer of electro-luminescent displays. From 1995 to 2000, Dr. Wagner served as a strategic adviser to the management of Ericsson Mobile. From 1984 to 1992, Dr. Wagner was a founder and served as chairman of Technophone, a mobile telephone manufacturer which was the worldwide number three in sales prior to its acquisition by Nokia in 1991. From 1973 to 1977, Dr. Wagner served as the assistant secretary general of the UNDP. From 1969 to 1973, Dr. Wagner served as the chief executive officer of SONAB AB, then Sweden's second largest communication equipment manufacturer. From 1963 to 1969, Dr. Wagner served as the chief operating officer of Incentive AB, then Sweden's largest technical conglomerate.

### **Tal Barnoach, Executive Vice Chairman**

Mr. Barnoach (43) was appointed to the Board of Directors in January 2006 as a non-executive director. In September 2006, Mr. Barnoach was appointed by the Board of Directors as Executive Vice Chairman, with the intent that he devotes more time to certain executive assignments and responsibilities relating to the Company's operations. Mr. Barnoach is an expert in the areas of enterprise software and the Internet. Since 1994 Mr. Barnoach has served as chief executive officer & chairman of S.E.A Multimedia and led that company's IPO in London in 1996. In 1999, Mr. Barnoach was appointed chairman of Orca Interactive Ltd., a public company traded on AIM since October 2004. From 2000 and until 2003, Mr. Barnoach was the chairman of Icognito and Dotomi. In 2002 he co-founded BelnSync, a company that developed a secure peer to peer synchronization solution and he is serving as the chief executive officer of that company. Mr. Barnoach holds a BA in economics from the University of Tel-Aviv.

### **Shimon Laor, Non-Executive Director**

Mr. Laor (40) serves as Finance Director of the Company in a part-time capacity. He served as the Chief Financial Officer of Emblaze until August 2000. Since then he has served as a non-executive director on the Emblaze board and has been engaged in private business initiatives. Mr. Laor also serves as a non-executive director of Orca Interactive Ltd. and Visual Defence Inc., partly-owned subsidiaries of Emblaze. Prior to joining Emblaze in August 1995, he was an economist at the Head Office Foreign Currency Division of the First International Bank of Israel.

### **Guy Bernstein, Non-Executive Director**

Mr. Bernstein (39) was appointed to the Board in January 2006 as non-executive director. Mr. Bernstein is the chief executive officer of Emblaze Ltd. since December 2006. Prior to this appointment, he served as Emblaze's chief financial officer since April 2004. Prior to joining Emblaze Ltd., Mr. Bernstein served as chief financial and operations officer of Magic Software Enterprises (NASDAQ: MGIC), a position he had held since 1999. At Magic, Mr. Bernstein's responsibilities included the overseeing of all finance operations, legal and M&A worldwide including budget planning, sales forecasting, board and SEC reporting and investor relations. Guy joined Magic from Kost, Forer Gabbay & Kasierer, a member of Ernst & Young Global, where he acted as senior manager from 1994 to 1997. Mr. Bernstein is a Certified Licensed Public Accountant and holds a BA in Accounting.

## Board of Directors

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### **Moshe Leder, Director (Resigned from the board in September 2006)**

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Mr. Leder (49) was the chief executive of Emblaze V CON with effect from June 2006 and appointed to the Board in July 2006. Mr. Leder has over 18 years of sales, business development, marketing and general management experience. Mr. Leder served as general manager of NiceVision EMEA at NICE Systems (NASDAQ:NICE), responsible for all EMEA business and customer facing activities. Between 2003 and 2004, he served as executive vice-president for sales & marketing at Flash Networks. Between 2000 and 2003 he was vice-president at AMDOCS (NYSE: DOX), leading the billing division's world-wide business activities. Previously, he was with Magic Software (NASDAQ:MGIC), progressing from being regional account manager to the position of VP & managing director for Israel, Africa & APAC regions. Mr. Leder holds a BA degree in Economics & Business from Tel-Aviv University and an MBA degree from University of Toronto, Canada.

### **Naamit Salomon, Non-Executive Director (Resigned from the board in March 2007)**

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Ms. Salomon was appointed to the Board in July 2006 as a non-executive director and external director of the Company. She has been the VP Finance of Formula Systems Ltd. since August 1997. Ms. Salomon also serves as a director of Magic Software Enterprises Ltd., Sapiens International and BluePhoenix Solutions Ltd. From 1990 to August 1997, Ms. Salomon was a controller of two large, privately held companies in the Formula Group. Ms. Salomon holds a BA degree in economics and business administration from Ben-Gurion University and an LL.M. degree from the Bar-Ilan University.

### **David Leichner, Non-Executive Director (Resigned from the board in May 2007)**

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Mr. Leichner (44) was appointed to the Board in July 2006 as a non-executive director and external director of the Company. Mr. Leichner is chief marketing officer at Telrad Networks, a leading provider of products and solutions for the implementation of next generation networks. At Telrad, Mr. Leichner is responsible for developing and executing the company's marketing and product strategy. Prior to Telrad, Mr. Leichner was a vice-president of marketing at Unipier Ltd., a provider of service delivery solutions to the mobile telecoms industry. Mr. Leichner joined Unipier Ltd. from Magic Software Enterprises Ltd. (NASDAQ: MGIC), where he was vice president of Worldwide Marketing from 1998 to 2004. Prior to Magic, Mr. Leichner held various international marketing management and technical positions at Emultek, Information Builders, Bezeq Communications, TRW Space and Defense Systems and Salomon Brothers. Mr. Leichner holds a BA in Computer Science and a MBA in International Business from the City University of New York.

### **David Blass, Non-Executive Director (Appointed in May 2007)**

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Mr. David Blass (64) was appointed by the Board of Directors in May 2007. During the years 1993 through 1999, Mr. Blass was Managing Director of the Investment Company for Industrial Development Bank of Israel Ltd., chairman of the board of directors of two companies, a director of two public companies and a member of the investment committee of a venture capital firm. From 1999 until 2003, Mr. Blass was Deputy General Manager and Head of Banking and Credit Division at the Industrial Development Bank of Israel Ltd. Mr. Blass holds a BA in economics from the Bar-Ilan University and a Master of Business Administration (MBA) from the Tel Aviv University.

## Corporate Governance

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The Financial Reporting Council published its new Combined Code in July 2003, which was implemented on 1 November 2003. It incorporated the major recommendations of the Higgs review and also of Sir Robert Smith's review of audit committees. It also repeated the requirements to comply with the Directors Remuneration Report Regulations and the Internal Control guidance of the Turnbull Report. The new Combined Code of July 2003 (the "Code") supersedes and replaces the Combined Code issued by the Hampel Committee in June 1998.

The Code's overall aim is to "enhance board effectiveness and to improve investor confidence by raising standards of corporate governance."

Incorporated in Israel, Zone-IP Ltd. is listed on the AIM Market of the London Stock Exchange and the board of directors of Zone-IP (the "Board") has therefore decided, as a matter of best corporate practice, that the Company should seek to comply with the main provisions of the Code, insofar as possible and appropriate given the Company's size, the constitution of the Board and taking into account the Corporate Governance Guidelines on AIM companies published by the Quoted Companies Alliance in July 2005.

### The Board

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During the year ended December 2006, the Board comprised the following:

Dr. Hans Wagner, the Chairman

Tal Barnoach, the Executive Vice Chairman

Shimon Laor, a non-executive director

Guy Bernstein, a non-executive Director

Moshe Leder, Director <sup>1</sup>

Naamit Salomon, a non-executive Director <sup>2</sup>

David Leichner, non-executive Director <sup>3</sup>

<sup>1</sup> Resigned in September 2006

<sup>2</sup> Resigned in March 2007

<sup>3</sup> Resigned in May 2007

In March 2007, Ms. Naamit Salomon resigned from the Board due to conflict of interest with other directorships she holds.

In May 2007, Mr. David Leichner resigned from the Board due to conflict of interest with other responsibilities and services he agreed to undertake.

The Chairman, Dr. Hans Wagner, is acting as a non-executive Chairman and he does not receive any remuneration. On May 02, 2007, Dr. Wagner purchased 2,716,395 ordinary shares of the Company, equivalent to 5.33 per cent. of the issued voting share capital of Zone-IP and is therefore not considered under the Code to be independent.

At the same time, Mr. Tal Barnoach purchased 905,465 ordinary shares of the Company, equivalent to 1.78 per cent. of the issued voting share capital of the Company and is therefore not considered under the Code to be independent.

Shimon Laor and Guy Bernstein are appointees of significant shareholders of the Company and they would therefore not be deemed to be independent.

The Chairman and non-executive directors have service contracts with the Company. Details of their respective terms are set out in the Report on Directors' Remuneration.

The Board meets on a regular basis to discuss the overall direction and strategic plan of the Company. The Board also monitors the Company's budget, performance and achievements.

Prior to each Board meeting, each director receives information on the performance and progress of the Company since the last Board meeting as well as background material related to the issues for discussion at the meeting itself.

There is in place a procedure under which the directors, in furtherance of their duties, are able to take professional advice, if necessary, at the Company's expense.

## Corporate Governance

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The Israeli Companies Law requires the Company to appoint two "External Directors" who meet certain statutory criteria of independence. Under Israeli law, the initial term of an External Director is three years and the term may be extended for an additional three-year period. Zippora Dekel and W. Robert Genieser were appointed as the External Directors at the Extraordinary General Meeting held on 21 April 2005 until the conclusion of the Annual General Meeting to be held in 2008, but both resigned from the Board in February 2006. Naamit Salomon and David Leichner were appointed as External Directors at the Extraordinary General Meeting held on 4 January 2006 until the conclusion of the Annual General Meeting to be held in 2009 but they both resigned during 2007 due to conflict with other responsibilities and directorships. The Company intends to propose two new directors for appointment at its next Annual General Meeting, who will assume the position of the External Directors.

Except for the External Directors, directors are subject to re-election at every Annual General Meeting.

### Board Committees

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The Board has established Audit, Remuneration and Nomination Committees. The duties of these committees are set out clearly in formal terms of reference, which are available for inspection upon request.

### Audit Committee

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Until April 2006, the Audit Committee was chaired by Zippora Dekel. The other members were Shimon Laor and W. Robert Genieser. On 5 April 2006, the Board appointed Naamit Salomon and David Leichner to serve on the Audit Committee, with Naamit Salomon as the chairperson. On 16 May 2006 the Board appointed the third member of the Audit Committee, Tal Barnoach, as required by Israel law. In September 2006, Mr. Barnoach was appointed to the position of Executive Vice-Chairman and hence could no longer serve as a member of the Audit Committee. In May 2007, the Board appointed Mr. David Blass as a director and member of the Audit Committee. Naamit Salomon and David Leichner both resigned during 2007 due to conflict with other responsibilities and directorships and the Company intends to suggest two new directors for appointment in its next Annual General Meeting that will assume the position of the External Directors and be appointed as members of the Audit Committee.

Under its terms of reference, the Audit Committee is required to oversee the relationship with the company's external auditors, to review the Company's preliminary results, interim results and financial statements and to monitor compliance with statutory and listing requirements for any exchange on which the Company's shares are quoted.

The Audit Committee also reviews the Company's internal control and risk management as well as the Company's cash investment policy.

The Company's Chairman and Chief Financial Officer may attend meetings at the Committee's request.

### Remuneration Committee

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Until April 2006, the Remuneration Committee was chaired by Dr. Hans Wagner and the other members were Zippora Dekel and W. Robert Genieser. On 5 April, 2006, the Board appointed Dr. Hans Wagner, Naamit Salomon and David Leichner to serve on the Remuneration Committee, with Dr. Hans Wagner as the chairman. Naamit Salomon and David Leichner both resigned from the Board in May 2007 and the Company intends to appoint new members in their stead after its next Annual General Meeting.

The Remuneration Committee approves the remuneration of all senior executives in the Company and is responsible for making recommendations to the Board on the Company's framework of executive remuneration and for determining on behalf of the Board the remuneration package for each executive director.

The remuneration of non-executive directors is determined by the entire Board, but the non-executive directors do not participate in Board discussions or vote on matters relating to their own fees.

## Corporate Governance

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### **Nomination Committee**

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The Board has established a Nomination Committee which leads the process for Board appointments and makes recommendations to the Board. Until April 2006, the Nomination Committee was chaired by Dr. Ingo Potthof and its other members were Zippora Dekel and W. Robert Genieser. On 5 April 2006, the Board appointed Dr. Hans Wagner, David Leichner and Shimon Laor to serve on the Nomination Committee, with Dr. Hans Wagner as the chairman. On 30 May 2006, Guy Bernstein was appointed to serve on the Nomination Committee and Shimon Laor stepped down. David Leichner resigned from the Board in May 2007 and the Company intends to appoint a new member in his stead after the its next Annual General Meeting.

The Nomination Committee leads the process for Board appointments and makes recommendations to the Board.

### **Relations with shareholders**

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The Company welcomes dialogue with its shareholders and communicates with them through its interim and annual reports.

At the Annual General Meeting, shareholders can raise questions with the directors. Separate resolutions are proposed on each substantially different issue so that each receives proper consideration. Resolutions include the approval of the annual report and accounts. Proxy votes are announced after each resolution has been dealt with by a show of hands. Notice of the Annual General Meeting and related documentation are sent to shareholders at least 35 days in advance.

## Report on Director's Remuneration

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### Policy on remuneration of directors

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The remuneration of the non-executive Directors is set by the Remuneration Committee and approved by the Board, subject to the approval of the Annual General Meeting.

The remuneration of directors is set below:

Dr. Hans Wagner	None (only reimbursement of expenses)
Mr. Tal Barnoach	£20,000 gross per annum paid quarterly in arrears
Mr. Shimon Laor	£20,000 gross per annum paid quarterly in arrears (£10,000 for his role as a Director and £10,000 for his role as part-time Finance Director)
Mr. Guy Bernstein	None (only reimbursement of expenses)
Ms. Naamit Salomon	£20,000 gross per annum paid quarterly in arrears
Mr. David Leichner	£20,000 gross per annum paid quarterly in arrears
Mr. Moshe Leder	None (served as CEO of the Company's subsidiary, Emblaze V CON)

### Share Options

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Only Mr. Shimon Laor has benefited from the Company's share option scheme. On 13 July 2006, Mr. Laor was granted with 250,000 options at an exercise price of 0.24p (the fair market value of the grant date), which vest in four equal installments on each of the first, second, third and fourth anniversary as of the grant date.

It is the policy of the Company to grant share options under its employee share schemes to all its employees, directors and advisors. Options to acquire the Company's shares are granted in addition to other forms of remuneration. The price at which shares may be acquired is the fair market value at the date of grant. The exercise of options generally phased over four years. The grant or exercise of options may be linked to a performance target.

### Service Contracts

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Non-executive Directors have service contracts with the Company. With the exception of the two External Directors, who are appointed for terms of three years at a time as required by Israeli law, each Non-Executive Director is subject to re-election at each Annual General Meeting. None of the Directors is involved in any discussion with the Board or any committee of the Board relating to their own remuneration, nor do they participate in any vote on their remuneration by the Board or any committee of the Board.

The fees paid to Non-Executive Directors are determined with reference to available information on the fees paid in other companies of broadly similar size and market cap. Non-executive Directors are entitled to reimbursement of reasonable out-of-pocket expenses.

# Independent Auditors' Report

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## to the shareholders of Zone-IP Ltd.



We have audited the accompanying financial statements of Zone-IP Ltd. (formerly Ki-Bi Mobile Technologies Ltd.) ("the Company") and its subsidiary ("the Group"), which comprise the consolidated balance sheets as of 31 December 2006 and 2005, and the consolidated statements of income, consolidated statements of changes in equity and consolidated statements of cash flows for the year ended 31 December 2006 and for the period from 9 August 2005 (date of inception) to 31 December 2005, and a summary of significant accounting policies and other explanatory notes.

### **Management's Responsibility for the Financial Statements**

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Management is responsible for the preparation and fair presentation of these financial statements in accordance with International Financial Reporting Standards. This responsibility includes: designing, implementing and maintaining internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error; selecting and applying appropriate accounting policies; and making accounting estimates that are reasonable in the circumstances.

### **Auditors' Responsibility**

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Our responsibility is to express an opinion on these financial statements based on our audits. We conducted our audits in accordance with International Standards on Auditing. Those standards require that we comply with ethical requirements and plan and perform the audit to obtain reasonable assurance whether the financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditors' judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate for the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of accounting estimates made by management, as well as evaluating the overall presentation of the financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

### **Opinion**

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In our opinion, the consolidated financial statements present fairly, in all material respects, the financial position of the Group as of 31 December 2006 and 2005, and of its financial performance and its cash flows for the year ended 31 December 2006 and for the period from 9 August 2005 (date of inception) to 31 December 2005, in accordance with International Financial Reporting Standards.

### **Kost Forer Gabbay & Kasierer**

A Member of Ernst & Young Global

Tel-Aviv, Israel

31 May 2007

## Consolidated Balance Sheets

U.S. DOLLARS IN THOUSANDS (EXCEPT SHARE AND PER SHARE DATA)

	Note	2006	31 December 2005
<b>ASSETS</b>			
CURRENT ASSETS:			
Cash and cash equivalents		1,613	2,256
Restricted cash		237	–
Short-term available-for-sale marketable securities	3	3,974	–
Trade receivables (net of allowance for doubtful accounts – \$ 179 and \$ 0 at 31 December 2006 and 2005, respectively)		1,660	2,102
Other accounts receivable and prepaid expenses	4	387	330
Inventories	6	1,407	1,267
Total current assets		9,278	5,955
NON-CURRENT ASSETS:			
Long-term available-for-sale marketable securities	5	1,505	–
Property and equipment, net	7	501	491
Intangible assets, net	8	894	1,138
Total non-current assets		2,900	1,629
Total assets		12,178	7,584
<b>LIABILITIES AND EQUITY</b>			
CURRENT LIABILITIES:			
Short-term bank credit	9	515	367
Trade payables		1,549	1,264
Related party	16	513	331
Government grants	11	577	673
Employees and payroll accruals		777	1,030
Deferred revenues		471	141
Accrued expenses and other liabilities	10	639	400
Total current liabilities		5,041	4,206
NON-CURRENT LIABILITIES:			
Government grants	11	847	688
Total liabilities		5,888	4,894
EQUITY:			
Ordinary shares		109	66
Share premium		12,989	3,539
Net unrealized loss reserve		(10)	–
Foreign currency translation reserve		(2)	(2)
Accumulated deficit		(6,796)	(913)
Total equity		6,290	2,690
Total liabilities and equity		12,178	7,584

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

## Consolidated Statements of Operations

U.S. DOLLARS IN THOUSANDS (EXCEPT SHARE AND PER SHARE DATA)

	Note	For the year ended 31 December 2006	From 9 August 2005 (date of inception) to 31 December 2005
<b>Continuing Operations:</b>			
Revenues	15a	6,577	4,532
Cost of revenues		(3,344)	(1,418)
Gross profit		3,233	3,114
Operating expenses:			
Research and development		3,018	841
Selling and marketing		3,816	1,720
General and administrative		1,714	423
Total operating expenses		8,548	2,984
Operating (loss)/profit		(5,315)	130
Financial income	15d	175	–
Financial expenses, net	15d	(212)	(22)
(Loss)/profit for the period from continuing operations		(5,352)	108
<b>Discontinued Operations:</b>			
Loss for the period from discontinued operations	15b	(531)	(1,021)
Loss		(5,883)	(913)
Loss per share:			
Basic and diluted loss per share from continuing operations		\$(0.13)	–
Basic and diluted loss per share from discontinued operations		\$(0.02)	\$(0.03)
Basic and diluted loss per share		\$(0.15)	\$(0.03)
Weighted average number of shares used in computing basic and diluted loss per share		40,083,881	30,672,152

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

## Consolidated Statements of Changes in Equity

U.S. DOLLARS IN THOUSANDS (EXCEPT SHARE AND PER SHARE DATA)

	Share capital	Share premium	Net unrealized loss reserve	Foreign currency translation adjustments reserve	Accumulated deficit	Total equity	Total recognized expense
Balance as of 9 August 2005 (date of inception)	–	–	–	–	–	–	–
Issuance by EVC of shares, net of issuance expenses (Note 13c)	66	3,737	–	–	–	3,803	–
Assumption of net liabilities of Esys Operation (Note 1c)	–	(198)	–	–	–	(198)	–
Loss	–	–	–	–	(913)	(913)	(913)
Foreign currency translation adjustments	–	–	–	(2)	–	(2)	(2)
Balance as of 31 December 2005	66	3,539	–	(2)	(913)	2,690	(915)
Reverse acquisition of net assets of Zone IP, net of issuance expenses (Note 2a)	43	9,450	–	–	–	9,493	–
Net loss on available-for-sale financial assets	–	–	(10)	–	–	(10)	(10)
Loss	–	–	–	–	(5,883)	(5,883)	(5,883)
Balance as of 31 December 2006	109	12,989	(10)	(2)	(6,796)	6,290	(5,893)

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

## Consolidated Statements of Cash Flows

U.S. DOLLARS IN THOUSANDS (EXCEPT SHARE AND PER SHARE DATA)

	Year ended 31 December 2006	From 9 August 2005 (date of inception) to 31 December 2005
<b>Cash flows from operating activities:</b>		
Loss	(5,883)	(913)
Adjustments to reconcile the loss to net cash used in operating activities:		
Loss from discontinued operations	531	1,021
Depreciation and amortization	547	219
Decrease/(increase) in trade receivables	453	(2,102)
Decrease/(increase) in other accounts receivable and prepaid expenses	153	(330)
(Increase)/decrease in inventories	(221)	231
Increase in trade payables	155	1,264
(Decrease)/increase in employees and payroll accruals	(253)	468
Increase in accrued expenses and other liabilities	571	521
Increase in short and long-term Government grants payables	63	–
Net cash flows (used in)/provided by continuing operating activities	(3,884)	379
Net cash flows used in discontinued operating activities (3)	(772)	(780)
Net cash used in operating activities	(4,656)	(401)
<b>Cash flows from investing activities:</b>		
Purchase of property and equipment	(232)	(110)
Acquisition of assets from VCON (4)	–	(1,631)
Restricted cash	(237)	–
Investment in marketable securities	(3,083)	–
Proceeds from sale of marketable securities	6,650	–
Net cash provided by/(used in) investing activities	3,098	(1,741)
<b>Cash flows from financing activities:</b>		
Increase in short-term bank credit	148	367
Issuance of shares, net	–	3,803
Increase in cash upon reverse acquisition	585	–
Increase in related party	182	230
Net cash provided by financing activities	915	4,400
(Decrease)/increase in cash and cash equivalents	(643)	2,258
Effect of exchange rate changes on cash and cash equivalents	–	(2)
Cash and cash equivalents at beginning of period	2,256	–
Cash and cash equivalents at end of period	1,613	2,256

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

## Notes to the Consolidated Statements of Cash Flows

U.S. DOLLARS IN THOUSANDS (EXCEPT SHARE AND PER SHARE DATA)

	Year ended 31 December 2006	From 9 August 2005 (date of inception) to 31 December 2005
<b>(1) Supplemental disclosure of cash flow activities:</b>		
Interest paid	49	12
Transfer from inventories to property and equipment	81	–
<b>(2) Non cash activities – acquisition of Esys Operation:</b>		
Fixed assets	–	19
Related party	–	(101)
Employee accruals	–	(116)
Net liabilities assumed	–	(198)
Issuance of shares – reduction of share premium	–	198
Net cash outflow	–	–
<b>(3) Net cash flows used in discontinued operating activities:</b>		
Loss from discontinued operations	(531)	(1,021)
Less – (decrease)/increase in accrued expenses associated with discontinued operations	(241)	241
	(772)	(780)
<b>(4) Acquisition of assets from VCON:</b>		
The fair values of the net assets at the date of acquisition were as follows:		
Inventories	–	1,498
Property and equipment, net	–	494
Intangible assets	–	1,225
Liability for Government grants	–	(1,361)
Accrued expenses and other liabilities	–	(225)
Net cash outflow	–	1,631

# Notes to the Consolidated Financial Statements

U.S. DOLLARS IN THOUSANDS (EXCEPT SHARE AND PER SHARE DATA)

## 1 General

- (a) Zone IP Ltd. ("the Company") was incorporated on 29 August 2002 in Israel. In July 2006, the Company changed its name from Ki-Bi Mobile Technologies Ltd. ("Ki-Bi") to Zone-IP Ltd. The Company's Ordinary shares are traded on the AIM Market of the London Stock Exchange ("AIM").
- (b) At the end of May 2006, the Company signed an agreement with Emblaze V CON Ltd ("EVC") and its shareholders under which the Company agreed to acquire 100 per cent. of EVC's shares in exchange for the issuance of shares that will represent 60 per cent. of the outstanding shares of the Company immediately following the consummation of the agreement with EVC's shareholders.

The consummation of the agreement was approved by the shareholders at the Annual General Meeting ("AGM") of the Company that took place on 12 July 2006. The number of shares issued to the shareholders of EVC was 30,672,152. Due to the size of EVC in relation to the size of the Company, the acquisition constituted a reverse takeover under the AIM Rules – See Note 2a.

EVC was incorporated in August 2005 in Israel. Shortly after its incorporation EVC purchased a substantial portion of the assets, liabilities and employees of Vcon Telecommunications Ltd., for a consideration of \$1,600. The acquisition was accounted for under the purchase method.

The purchase price allocation, of the consideration as detailed in a study performed by an independent third party was as follows:

Purchase Price Allocation:

Consideration	1,600
Expenses of acquisition	31
	1,631
Inventory	1,498
Fixed assets	494
Intangible assets, see Note 8	1,225
Employee obligations	(225)
Government grants	(1,361)
	1,631

EVC and its wholly-owned subsidiary in the U.S. design, develop, manufacture and sell high-performance, multi-function conferencing systems designed for a variety of networks, including those based on the Internet protocol. EVC's systems facilitate interactive communication between remote users through videoconferencing, video streaming, audio conferencing and data collaboration. These systems are primarily targeted at business, distance learning, telemedicine and government.

EVC distributes its products worldwide, primarily through distributors and value-added resellers, as well as original equipment manufacturers. In addition, the Company maintains regional sales and support offices.

# Notes to the Consolidated Financial Statements

U.S. DOLLARS IN THOUSANDS (EXCEPT SHARE AND PER SHARE DATA)

## 1 General (continued)

### (c) Discontinued operations-Esys

Effective 15 August 2005, Emblaze Ltd., the parent company of EVC entered into an agreement ("the Agreement") with EVC and its other shareholders to contribute all of the assets and liabilities of the "Esys Operation", which consisted of Emblaze's assets and liabilities related to its line of business of providing customized, media centric solutions for mobile media, in consideration of the issuance of 8,542,183 Ordinary shares by EVC. The identification of the transferred assets and liabilities was agreed upon between Emblaze and the other shareholders pursuant to the agreement and related documents.

Since Emblaze Ltd. is the founder of EVC and its controlling shareholder, the assets received and liabilities assumed in this transaction were accounted for in a manner similar to that required for a pooling of interests and, accordingly, recorded at their historical cost. The excess carrying amount of liabilities assumed over assets purchased was accounted for as a reduction in share premium. Information regarding historical results of the Esys Operation for the period commencing 1 January 2005 through 9 August 2005 (date of inception) is not included in these financial statements as records of such information were not tracked and kept separately at Emblaze Ltd..

The carrying values of the assets and liabilities in the accounts of Emblaze Ltd. of the Esys Operation transferred to the Company consisted of the following:

Intangible assets *	–
Fixed assets	19
Liability to related party	(101)
Employee accruals	(116)
Net liabilities assumed	(198)
Issuance of Series A Preferred shares through reduction of share premium	198
Total consideration	–

\*The intangible assets acquired include intellectual property and other rights such as licenses and patents.

At the end of 2005, the Company decided to discontinue the Esys Operation due to its expected high loss.

### (d) Discontinued operations – Electronic content cards ("Cards")

Prior to the reverse takeover as described in b above, the Board of Directors of Ki-Bi had decided in April 2006 to cease the operations of its Cards business, including the termination of substantially all of its employee. In September, the Company signed an agreement with Spiral Solutions Ltd. according to which the Company's remaining Cards assets, including inventory, fixed assets and intellectual property were sold in consideration for \$373 which approximated the carrying value of the assets.

The operating expenses of the Cards business from the date of reverse takeover are presented on discontinued operations in the statement of operations.

## Notes to the Consolidated Financial Statements

U.S. DOLLARS IN THOUSANDS (EXCEPT SHARE AND PER SHARE DATA)

### 2 Significant Accounting Policies

The significant accounting policies applied in the preparation of the consolidated financial statements, on a consistent basis, are as follows:

#### (a) Reverse acquisition

As a result of the issuance of the Ordinary shares by the Company in July 2006, as described in Note 1b, the shareholders of EVC obtained control of the Company. Accordingly the transaction was accounted for as a reverse acquisition in accordance with IFRS 3, "Business Combinations". For financial reporting purposes, EVC (the legal subsidiary) is the acquirer and the Company (the legal parent) is the acquiree.

The consolidated financial statements prepared following the reverse acquisition are issued under the name of the Company, but they are a continuance of the financial statements of EVC. Because such consolidated financial statements represent a continuation of the financial statements of EVC:

- (i) the assets and liabilities of EVC have been recognized and measured in these consolidated financial statements at their pre combination carrying amounts.
- (ii) the retained earnings and other equity balances recognized in these consolidated financial statements are the retained earnings and other equity balances of EVC immediately before the business combination.
- (iii) the amount recognized as issued equity instruments in these consolidated financial statements has been determined by adding to the issued equity of EVC immediately before the business combination the cost of the combination determined as described in the following paragraph. However, the equity structure appearing in these consolidated financial statements (the number and type of equity instruments issued) reflects the equity structure of the Company, including the equity instruments issued by the Company to effect the combination.

These consolidated financial statements prepared following the reverse acquisition reflect the carrying values of the assets and liabilities of EVC (the acquirer for accounting purposes) and the fair values of the net assets of the Company (the acquiree for accounting purposes) in the amount of \$10,238. As substantially all of the net assets of the Company were comprised of cash and cash equivalents and marketable securities, the fair value of the Company was equivalent to their carrying value. The direct transaction costs incurred in connection with the issuance of the Ordinary shares in the amount of \$745 has been recorded as a reduction in additional paid-in capital.

The revenues and loss of the Group for the year ended 31 December 2006, had the reverse acquisition occurred on 1 January 2006, would have been \$6,577 and \$8,517 respectively.

#### (b) Basis of preparation

These financial statements are prepared in accordance with International Financing Reporting Standards ("IFRS"). The financial statements are prepared on a historical cost basis except for marketable securities which are measured at fair value.

## Notes to the Consolidated Financial Statements

U.S. DOLLARS IN THOUSANDS (EXCEPT SHARE AND PER SHARE DATA)

### 2 Significant Accounting Policies (continued)

#### (c) Functional currency and translation

The majority of the Group's sales are made outside of Israel in non Israeli currencies, mainly the U.S. dollar. A substantial portion of the Group's expenses, mainly selling and marketing expenses and service costs is incurred in U.S. dollars. Accordingly, the U.S. dollar is the currency of the primary economic environment of the Company and its subsidiaries, and thus its functional and presentation currency.

Transactions in non-US dollar currencies are translated into dollars at the exchange rate on the transaction date. Monetary assets and liabilities in non-dollar currencies are retranslated into dollars at the exchange rate on balance sheet date. All exchange rate differences are recorded in the statement of operations.

Following are data about the representative exchange rate of the dollar in relation to the new Israeli shekel ("NIS"), Euro and the GBP:

As of	Exchange rate of U.S. \$1 NIS	Exchange rate of U.S. \$1 Euro	Exchange rate of U.S. \$1 GBP
31 December 2006	4.22	0.76	0.51
31 December 2005	4.60	0.85	0.58
Change during the year ended	per cent.	per cent.	per cent.
31 December 2006	(8.2)	(10.6)	(12.1)
31 December 2005	6.8	15.3	11.8

#### (d) Principles of consolidation

The consolidated financial statements include the accounts of the Company and its subsidiaries ("the Group"). Intercompany transactions and balances, including profits from inter-company sales not yet realized outside the Group, have been eliminated upon consolidation.

The following wholly owned subsidiaries are consolidated as of 31 December 2006:

Emblaze V CON Ltd.  
Emblaze – V CON Inc.(U.S.)  
Emblaze – V CON GmbH (Germany)  
Emblaze V CON S.A.R.L. (France)  
Ki-Bi Ltd. – U.K.  
Ki-Bi Hong Kong

#### (e) Cash and cash equivalents

Cash includes cash on hand and cash in banks. Cash equivalents are short-term, highly liquid investments that are readily convertible to known amounts of cash with original maturities of three months or less and that are subject to an insignificant risk of change in value.

Bank overdraft as of 31 December 2005, in the amount of \$367 has been reclassified from cash and cash equivalents to conform with current year's presentation.

#### (f) Restricted cash

Restricted cash is due to a bank guarantee.

#### (g) Trade receivables

Trade receivables are recognized and carried at original invoice amounts less an allowance for any uncollectible amounts. An estimate for doubtful debts is made when collection of the full amount is no longer probable. Bad debts are written-off when identified.

## Notes to the Consolidated Financial Statements

U.S. DOLLARS IN THOUSANDS (EXCEPT SHARE AND PER SHARE DATA)

### 2 Significant Accounting Policies (continued)

(h) **Inventories**

Inventories are stated at the lower of cost or net realizable value. The cost of raw materials has been determined by the "average cost" method. Cost of finished products includes average direct manufacturing costs and overhead expenses.

(i) **Property and equipment**

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

	<b>Per cent.</b>
Computers and peripheral equipment	33
Office furniture and other equipment	6-15
Leasehold improvements	20

(j) **Intangible assets**

Acquired technologies are recorded at fair value as of the date of the acquisition. Following initial recognition, the assets are carried at cost and amortized using the straight-line method over the estimated useful life during which benefits are expected to be derived. The estimated benefit period is 7 years for core technology and 4 years for other developed technology.

(k) **Impairment of non-financial assets**

The Group assesses at each reporting date whether there is an indication that an asset may be impaired. If any such indication exists, or when annual impairment testing for an asset is required, the Group makes an estimate of the asset's recoverable amount. An asset's recoverable amount is the higher of an asset's or cash-generating unit's fair value less costs to sell and its value in use and is determined for an individual asset, unless the asset does not generate cash inflows that are largely independent of those from other assets or groups of assets. Where the carrying amount of an asset exceeds its recoverable amount, the asset is considered impaired and is written down to its recoverable amount. In assessing value in use, the estimated future cash flows are discounted to their present value using a pre-tax discount rate that reflects current market assessments of the time value of money and the risks specific to the asset. As of 31 December 2006 and 2005, no impairment losses have been identified.

(l) **Government grants**

Royalty-bearing grants are recognized where there is reasonable assurance that the grant will be received and all related conditions will be complied with. Grants are related to research and development costs and are recorded as a reduction in these expenses when there is reasonable assurance that the grants will not be repaid based on estimate future sales. Such grants are recorded as a liability when repayment is probable.

(m) **Research and development costs**

Research costs are expensed as incurred. Development costs in respect of individual projects are capitalized only if future recoverability is reasonably assured and various other criteria as set forth in IAS 38 ("Intangible Assets") have been met.

## Notes to the Consolidated Financial Statements

U.S. DOLLARS IN THOUSANDS (EXCEPT SHARE AND PER SHARE DATA)

### 2 Significant Accounting Policies (continued)

(n) **Revenue recognition**

The Company's products are generally a bundled hardware and software solution that are delivered together. The Company sells its products primarily through distributors and resellers.

Revenues from product sales are recognized when persuasive evidence of an agreement exists, delivery of the product has occurred, the fee is fixed or determinable, and collectibility is probable. Revenues from software subscriptions are deferred and recognized on a straight-line basis, over the term of the software subscription agreement.

The Company's determination of fair value of each element in a multiple-element arrangement is based on vendor specific objective evidence (VSOE). The Company aligns its assessments of VSOE for the elements in the transaction to the price charged when the same element is sold separately. The Company has analyzed all of the elements included in its multiple-element arrangements, and determined that it has sufficient VSOE to allocate revenue to the maintenance and support, consulting and training ("professional") services components of its license arrangements. The Company sells its professional services separately, and accordingly it has established VSOE for professional services based on its hourly or daily rates. VSOE for maintenance and support is determined based upon the customer's actual renewal rates for these elements.

(o) **Income taxes**

The Company accounts for income taxes under the liability method of accounting. Under the liability method, deferred taxes are determined based on the differences between the financial statement and tax basis of assets and liabilities at enacted tax rates that will be in effect in the year in which the differences are expected to reverse. Deferred tax assets in respect of carryforward losses and other temporary deductible differences are recognized to the extent that it is probable that they will be utilized.

(p) **Basic and diluted net earnings/(loss) per share**

Basic earnings/(loss) per share are computed based on the weighted average number of shares outstanding during the period. Diluted net earnings/(loss) per share are computed based on the weighted average number of shares outstanding during each period, plus the potential dilution of equivalent shares considered outstanding during the period, in accordance with IAS No. 33, "Earnings per Share".

For the purpose of calculating the weighted average number of shares outstanding during the year (2006) in which the reverse acquisition occurred:

1. the number of shares outstanding from the beginning of 2006 to the acquisition date (12 July 2006) is deemed to be the number of shares issued by the Company to the shareholders of EVC; and
2. the number of shares outstanding from the acquisition date to the end of 2006 is the actual number of shares of the Company outstanding during that period.

Basic earnings per share for 2005 was calculated by dividing the profit or loss of EVC by the number shares issued by the Company to the shareholders of EVC in the reverse acquisition, adjusted to take into account the effect of the issuance of shares by EVC in 2005.

## Notes to the Consolidated Financial Statements

U.S. DOLLARS IN THOUSANDS (EXCEPT SHARE AND PER SHARE DATA)

### 2 Significant Accounting Policies (continued)

- (q) Financial instruments that potentially subject the Company to concentrations of credit risk consist principally of cash and cash equivalents, marketable securities and trade receivables.

The majority of the Company's cash and cash equivalents and marketable securities are invested in major banks in the United States and England, in U.S. dollars. Management believes that the financial institutions that hold the Company's investments are financially sound and that the portfolios are well-diversified, and accordingly, minimal credit risk exists with respect to these investments.

Trade receivables are mainly derived from sales to customers primarily located in the U.S. Europe and South East Asia.

- (r) **Fair value of financial instruments**

The carrying amounts of cash and cash equivalents, restricted cash, short-term bank credit, trade and other accounts receivable, trade payables, employees and payroll accruals, accrued expenses and other liabilities approximate their fair values due to the short-term maturity of these instruments.

Marketable securities (short and long-term) are presented at fair value based on quoted market prices.

- (s) **IFRS and IFRIC Interpretations not yet effective**

The Group has not early adopted IFRSs and IFRIC Interpretations that have been issued but are not effective as of 31 December 2006. Management expects that adoption of the following pronouncement will not have a material impact on the financial position and profit of the Group in the period of initial application.

1. **IFRS 7 – "Financial Instruments: Disclosures"**

IFRS 7, effective for financial years beginning on or after 1 January 2007, requires new disclosures to be presented in next year's financial statements on a comparative basis that will enable users to evaluate the significance of the Group's financial instruments and the nature and extent of risks arising from those financial instruments.

2. **IFRS 8 – "Operating Segments":**

IFRS 8 ("the Standard") discusses operating segments and replaces IAS 14. The Standard applies to companies whose securities are listed or undergoing listing for trade on any securities stock exchange. The Standard will be applicable to annual financial statements for periods commencing after 1 January 2009. The Standard can be applied early. The provisions of the Standard will be applied retrospectively, by restatement, unless the disclosure required is unavailable or impractical to obtain.

The Standard determines that an entity will adopt a management approach to segment reporting. The information reported would be that which management uses internally for evaluating the performance of operating segments and allocating resources to those segments.

3. **IFRIC 8 – Adoption of IFRS 2 discussing "Share-based Payment":**

IFRIC 8 discusses share-based payment transactions where part or all of the goods or services are not specifically identifiable. These goods or services are measured upon the date of grant as the difference between the fair value of the share-based payment and the fair value of the identifiable goods or services.

The Company believes that the adoption of IFRIC 8 is not expected to have any effect on the Company's financial statements for 2007.

## Notes to the Consolidated Financial Statements

U.S. DOLLARS IN THOUSANDS (EXCEPT SHARE AND PER SHARE DATA)

### 3 Short-term available-for-sale marketable securities

	Effective interest rate	31 December 2006		Market value
		Amortized cost	Unrealized losses	
Corporate debentures	5.25%	2,553	(8)	2,545
U.S. Government and agency debt	4.66%	949	(2)	947
Mutual funds	5.25%	482	–	482
		3,984	(10)	3,974

### 4 Other accounts receivable and prepaid expenses

	31 December	
	2006	2005
VAT and customs authorities	107	197
Prepaid expenses and other	252	101
Advances to vendors	22	23
Employee loans	6	9
	387	330

### 5 Long-term available-for-sale marketable securities

	Effective interest rate	31 December 2006		Market value
		Amortized cost	Unrealized losses	
<b>Mature after one year and less than five years:</b>				
Corporate debentures	5.60%	504	(2)	502
Foreign bonds denominated in U.S\$	5.39%	1,001	2	1,003
		1,505	–	1,505

### 6 Inventories

	31 December	
	2006	2005
Raw materials	600	810
Finished products	807	457
	1,407	1,267

## Notes to the Consolidated Financial Statements

U.S. DOLLARS IN THOUSANDS (EXCEPT SHARE AND PER SHARE DATA)

### 7 Property and equipment

	Computers and peripheral equipment	Office furniture and other equipment	Leasehold improvements	Total
Cost:				
Balance at 9 August 2005	–	–	–	–
Additions through purchase of VCON	494	–	–	494
Additions during the period	96	18	15	129
Balance at 31 December 2005	590	18	15	623
Additions during the period	146	7	160	313
Balance at 31 December 2006	736	25	175	936
Accumulated depreciation:				
Balance at 9 August 2005	–	–	–	–
Additions during the period	131	1	–	132
Balance at 31 December 2005	131	1	–	132
Additions during the period	272	1	30	303
Balance at 31 December 2006	403	2	30	435
Net carrying amount at 31 December 2006	333	23	145	501
Net carrying amount at 31 December 2005	459	17	15	491

### 8 Intangible assets

	Core technology	Developed technology	Total
Cost:			
Balance at 9 August 2005	–	–	–
Additions through purchase of VCON	577	648	1,225
Balance at 31 December 2005	577	648	1,225
Additions during the period	–	–	–
Balance at 31 December 2006	577	648	1,225
Accumulated amortization:			
Balance at 9 August 2005	–	–	–
Additions during the period	43	44	87
Balance at 31 December 2005	43	44	87
Additions during the period	82	162	244
Balance at 31 December 2006	125	206	331
Net carrying amount at 31 December 2006	452	442	894
Net carrying amount at 31 December 2005	534	604	1,138

### 9 Short-term bank credit

Represents bank overdrafts which bear interest at an annual rate of 7 per cent.

## Notes to the Consolidated Financial Statements

U.S. DOLLARS IN THOUSANDS (EXCEPT SHARE AND PER SHARE DATA)

### 10 Accrued expenses and other liabilities

	31 December	
	2006	2005
Royalties payable to third parties *	245	61
Other liabilities and accrued expenses	394	339
	639	400

\* EVC is committed to pay royalties to various software suppliers based on proceeds from the sale of products developed pursuant to the agreements, which are limited in time and territory.

### 11 Liabilities for Government grants

	31 December	
	2006	2005
Total liability (See Note 1a)	1,361	1,361
Accrued interest	63	–
Less – current portion	577	673
Non current portion	847	688

### 12 Commitments and contingent liabilities

#### (a) Contingent liabilities

Some of the core technologies of the Company were financed by the Government of Israel through the Office of the Chief Scientist of the Ministry of Industry, Trade and Labor ("OCS") and by the BIRD-Fund by participations in a portion of research and development expenditures incurred by VCON.

The Company is obligated, due to the acquisition of VCON's assets and liabilities (see Note 1b), to pay royalties amounting to 3-5 per cent. of the sales of the products and other related revenues generated from such financed technologies, up to the amount of grants received from the OCS, plus interest at LIBOR, and up to an amount equal to 150 per cent. of grants received from BIRD-F, linked to the United States Consumer Price Index.

As of 31 December 2006, the Company recorded a liability for grants received by VCON in the amount of \$1,361. With respect to these grants, the Company has an outstanding contingent obligation to pay royalties in the amount of \$4,181 in respect of projects for which there is a reasonable assurance that part or all of the grants received will not be repaid. The Company will revise its recorded liability related to this contingent obligation if facts and circumstances arise that will cause the Company to change its estimates of future sales.

- (b) The Company and its subsidiaries lease their facilities, under non-cancelable operating lease agreements, which expire on various dates, the latest of which is 2007. Future minimum payments under non-cancelable operating lease agreements, as of 31 December 2006, are \$254 for 2007.
- (c) Royalty commitments – see Note 10.

## Notes to the Consolidated Financial Statements

U.S. DOLLARS IN THOUSANDS (EXCEPT SHARE AND PER SHARE DATA)

### 13 Equity

- (a) As of 31 December 2006, the Company's Ordinary shares of NIS 0.01 par value consist of 70,000,000 authorized shares. As of 31 December 2005 and 2006 the Company's Ordinary shares consist of 30,762,152 and 51,120,253 issued and outstanding shares, respectively.
- (b) In May 2005, prior to the reverse acquisition described in Note 1b, the Company's Ordinary shares were admitted to trading on AIM. Concurrently, the Company completed an initial public offering ("IPO") of its Ordinary shares and issued 10,204,076 Ordinary shares to institutional and other investors at a price of £0.98 per share, raising \$18,892 (before issuance expenses of \$2,452).
- (c) In December 2005, EVC issued 30,672,152 Ordinary shares in consideration of cash in the amount of \$3,803 (net of \$83 in respect of issuance expenses) and in consideration of the Esys Operation (see Note 1c).

(d) **Share-based payments**

1. **The Company**

In 2004, the Company implemented the 2004 Stock Option Plan ("the Zone IP Plan"). Under the plan, 900,000 options to purchase Ordinary shares were reserved for issuance. These options which may be granted to consultants, directors and employees will generally vest over a period of up to four years from the date of grant, and if not exercised, the options expire on the tenth anniversary of the date of grant. The exercise price of these options may be less than 100 per cent. of the fair value of the share at the date of grant. Any options which are cancelled or forfeited before expiration become available for future grants. In July 2006, the Company's shareholders resolved to increase the reserve of shares reserved for issuance under the Plan.

The total amount of options available for future grants as of 31 December 2006, amounted to 4,541,999.

A summary of the Company's stock option activities during the six month period from the date of the reverse acquisition, see Note 1a, to 31 December 2006, is as follows:

	<b>Options outstanding</b>	<b>Weighted average exercise price per share</b>
	<b>Number of options</b>	
Balance as of July 2006	349,902	\$0.36
Options granted *	250,000	\$0.44
Options forfeited	(149,901)	\$0.70
Balance as of 31 December 2006	450,001	\$0.29
Number of shares exercisable as of 31 December 2006	155,001	\$0.13

\* The weighted average fair value of the options granted in 2006 was \$0.33. The fair value of the options granted is estimated as of the date of grant using a Black and Scholes option pricing model taking into account the terms and conditions upon which the options were granted. The following table lists the inputs to the model used for the period ended 31 December 2006:

	<b>2006</b>
Dividend yield	0 per cent.
Expected volatility	72 per cent.
Risk free interest rate	5.6 per cent.
Expected life of option (years)	8
Weighted average share price	\$0.44

## Notes to the Consolidated Financial Statements

U.S. DOLLARS IN THOUSANDS (EXCEPT SHARE AND PER SHARE DATA)

### 13 Equity (continued)

The expected volatility reflects the assumption that the historical volatility is indicative of future trends, which may not necessarily be the actual outcome.

The total expense in respect of share-based payments in 2006 was immaterial.

The weighted average remaining contractual life for the share options outstanding as at 31 December 2006, is 6 years.

The range of exercise prices for options outstanding at the end of the year was \$0.10 – \$0.14.

#### 2. EVC

In December 2005, the Company approved the 2005 Global Option Plan ("the Option Plan"). Under the Option Plan, options may be granted to the Company's employees and consultants to purchase Ordinary shares of the Company. The options generally vest in equal portions, mainly over a period of four years commencing on the date of grant.

The options expire 10 years after date of grant. The options granted under the Option Plan expire ten years from the date of grant or upon termination of the optionholder's employment (the employee has 90 days to exercise his vested options upon employment termination).

The Company has made an election that options granted pursuant to Section 102(b) of the Income Tax Ordinance (New Version) 1961 (the "Ordinance"), to optionholders who are Israeli residents be granted pursuant to the capital gains route.

The total number of Ordinary shares available for future grants as of 31 December 2006, amounted to 1,357,465.

### 14 Income taxes

#### (a) Israeli taxation

##### 1. Corporate tax rate:

On 25 July 2005, the Knesset (Israeli Parliament) passed the Law for the Amendment of the Income Tax Ordinance (No. 147), 2005, which prescribes, among others, a gradual decrease in the corporate tax rate in Israel to the following tax rates: 2006 – 31 per cent., 2007 – 29 per cent., 2008 – 27 per cent., 2009 – 26 per cent. and 2010 and thereafter – 25 per cent..

##### 2. EVC submitted an application to assign the programs of VCON under the Law for the Encouragement of Capital Investments, 1959 ("the Law") to EVC and thus enjoy the tax benefits (primarily reduced tax rates) of an "Approved Enterprise" as defined by the Law. The application was approved by the Israel Investment Center (a department of the Ministry of Industry, Trade and Labor).

The Company's production facilities in Israel have been granted "Approved Enterprise" status, for 6 investment programs approved under the Law. According to the provisions of the Law, the Company has elected the "alternative benefits" track, the waiver of grants in return for a tax exemption and, accordingly, the Company's income from the "Approved Enterprise" is tax exempt for a period of two years commencing with the year it first earns taxable income and to a reduced tax rate of 10 per cent. to 25 per cent. for an additional period of five to eight years (depending on the level of foreign investment in the Company).

The entitlement to the above benefits is conditional upon the fulfillment of the conditions stipulated by the above Law, regulations published there under and the letters of approval for the specific investments in "Approved Enterprises". In the event of failure to comply with these conditions, the benefits may be cancelled and the Company may be required refund the amount of the benefits, in whole or in part, including interest.

## Notes to the Consolidated Financial Statements

U.S. DOLLARS IN THOUSANDS (EXCEPT SHARE AND PER SHARE DATA)

### 14 Income taxes (continued)

The period of tax benefits, detailed above, is subject to limits of the earlier of 12 years from the commencement of production, or 14 years from the approval date. These limitation do not apply to the tax exempt period of the first two years.

Income from sources other than the "Approved Enterprise" during the benefit period will be subject to tax at the regular corporate tax rate.

On 1 April 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 a Beneficiary Enterprise, such as provisions generally requiring that at least 25 per cent. of the Beneficiary 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.

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, the Israeli subsidiary's existing Approved Enterprise 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. As of 31 December 2006, the Company did not generate income subject to the provision of the new law.

#### (b) Carry forward tax losses

As of 31 December 2006, the Company had carry forward tax losses of approximately \$6,000 (2005: \$6,900) that can be carried forward indefinitely.

As of 31 December 2006, EVC had carry forward tax losses of approximately \$3,951 (2005: \$0) that can be carried forward indefinitely.

As of 31 December 2006, the U.S. subsidiary had U.S. federal carry forward tax losses of approximately \$200 (2005: \$50) that can be carried forward and offset against taxable income for 15-20 years and expire between 2020-2025.

Management currently believes that since the Company and its subsidiaries have no history of ongoing profits it is not probable that the deferred tax asset in respect of the loss carryforwards and other temporary differences, in the amount of \$2,365 (2005: \$610), mainly due to research and development differences, will be realized.

#### (c) Tax assessments

To date, the Company and its Israeli subsidiary has not received any final tax assessments.

## Notes to the Consolidated Financial Statements

U.S. DOLLARS IN THOUSANDS (EXCEPT SHARE AND PER SHARE DATA)

### 15 Selected statement of operations data

(a) The following is a summary of revenues based on customer location:

	Year ended 31 December 2006	From 9 August 2005 (date of inception) to 31 December 2005
United States	1,496	1,141
Europe	3,094	2,218
Southeast Asia	1,767	1,079
Other	220	94
	<u>6,577</u>	<u>4,532</u>

(b) **Loss from discontinued operations:**

Research and development	–	173
Selling and marketing	–	411
General and administrative	531	437
	<u>531</u>	<u>1,021</u>

(c) **Salaries and employee benefits expense:**

Cost of revenues	219	47
Research and development	2,280	721
Selling and marketing	1,187	594
General and administrative	470	43
	<u>4,156</u>	<u>1,405</u>

(d) **Depreciation and amortization expense:**

Cost of revenues	286	87
Selling and marketing	8	9
General and administrative	253	123
	<u>547</u>	<u>219</u>

(e) **Financial expenses, net:**

Interest from bank deposits and marketable debt securities	175	–
Exchange rate differences and other	(87)	(11)
Interest and other bank charges	(125)	(11)
	<u>(37)</u>	<u>(22)</u>

### 16 Related party transactions

(a) **Compensation of key management personnel of the Group:**

Short-term employee benefits and other	297	257
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(b) **Transactions:**

1. Rent expenses	64	–
2. Transfer of Esys Operation see Note 1c.		
3. Amounts included in loss from discontinued operations (Note 15b) that were paid by Emblaze on behalf of the Company in 2005 amounted to \$522.		

(c) **Balances:**

Amount owed to Emblaze at 31 December 2005 and 2006 was \$331 and \$513, respectively.

**Z.ONE!P**

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