DSP GROUP, INC. 2005 ANNUAL REPORT

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, 2005 and 2004, 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, 2005. Our audits also included the financial statement schedule listed in the Index at Item 15(a). These financial statements and schedule are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements and schedule based on our audits.

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

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the consolidated financial position of the Company and its subsidiaries as of December 31, 2005 and 2004, and the consolidated results of their operations and their cash flows for each of the three years in the period ended December 31, 2005, 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, present 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.'s internal control over financial reporting as of December 31, 2005, 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, 2006 expressed, an unqualified opinion thereon.

/s/ Kost Forer Gabbay & Kasierer
KOST FORER GABBAY & KASIERER
A Member of Ernst & Young Global

Tel-Aviv, Israel
March 14, 2006

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DSP GROUP, INC.

CONSOLIDATED BALANCE SHEETS
U.S. dollars in thousands

	December 31,	
	2005	**2004**
ASSETS		
CURRENT ASSETS:		
Cash and cash equivalents	$ 50,460	$ 60,827*
Short-term investments	37,053	14,313*
Held-to-maturity marketable securities	71,875	60,184
Trade receivables, net	16,991	5,976
Deferred income taxes	1,227	1,168
Other accounts receivable and prepaid expenses	1,617	2,213
Inventories	12,686	9,469
TOTAL CURRENT ASSETS	191,909	154,150
PROPERTY AND EQUIPMENT, NET	11,704	6,683
LONG-TERM ASSETS:		
Long-term held-to-maturity marketable securities	185,828	195,671
Long-term prepaid expenses and lease deposits	670	628
Deferred income taxes	1,638	1,410
Severance pay fund	4,419	3,437
Intangible assets, net	2,337	3,482
Goodwill	1,500	1,500
	196,392	206,128
TOTAL ASSETS	$ 400,005	$ 366,961
LIABILITIES AND STOCKHOLDERS' EQUITY		
CURRENT LIABILITIES:		
Trade payables	$ 12,753	$ 7,830
Accrued compensation and benefits	10,736	9,421
Income taxes payables	11,511	17,083
Accrued expenses and other accounts payable	11,164	13,353
TOTAL CURRENT LIABILITIES	46,164	47,687
ACCRUED SEVERANCE PAY	4,707	3,784
STOCKHOLDERS' EQUITY:		
Preferred stock, $0.001 par value—Authorized shares: 5,000,000 at December 31, 2005 and 2004; Issued and outstanding shares: none at December 31, 2005 and 2004	—	—
Common stock, $0.001 par value—Authorized shares: 50,000,000 at December 31, 2005 and 2004; Issued and outstanding: 28,596,340 and 27,954,133 shares at December 31, 2005 and 2004, respectively	29	28
Additional paid-in capital	188,539	187,471
Treasury stock	(19,447)	(29,797)
Accumulated other comprehensive income	45	65
Retained earnings	179,968	157,723
TOTAL STOCKHOLDERS' EQUITY	349,134	315,490
TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY	$ 400,005	$ 366,961

* Reclassified

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

DSP GROUP, INC.

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

	Year ended December 31,		
	2005	2004	2003
Revenues	$ 187,225	$ 157,511	$ 152,875
Costs of revenues	101,074	80,368	83,077
Gross profit	86,151	77,143	69,798
Operating expenses:			
Research and development	40,290	32,147	25,599
Sales and marketing	13,119	11,292	11,977
General and administrative	7,398	7,112	6,953
Impairment of goodwill	—	4,304	—
In-process research and development write-off	—	2,682	2,727
Total operating expenses	60,807	57,537	47,256
Operating income	25,344	19,606	22,542
Financial and other income:			
Interest and other, net	10,166	8,522	7,947
Capital gains from available-for-sale marketable securities	—	44,448	241
Income before taxes on income	35,510	72,576	30,730
Taxes on income	6,037	21,482	5,375
Net income	$ 29,473	$ 51,094	$ 25,355
Net earnings per share:			
Basic	$ 1.04	$ 1.79	$ 0.91
Diluted	$ 0.99	$ 1.70	$ 0.86

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

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STATEMENTS OF CHANGES IN STOCKHOLDERS' EQUITY

U.S. dollars in thousands, except share data

	Number of shares of Common stock	Common stock amount	Additional paid-in capital	Treasury stock	Accumulated other comprehensive income	Retained earnings	Total comprehensive income	Total stockholders' equity
Balance at January 1, 2003	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
Issuance of treasury stock upon purchase of ESPP shares by employees	31	— *	—	732	—	(326)		406
Issuance of common stock upon exercise of stock options by employees	732	— *	11,659	—	—	—		11,659
Issuance of common stock upon purchase of ESPP shares by employees	38	— *	547	—	—	—		547
Issuance of treasury stock upon exercise of stock options by employees	114	— *	—	2,359	—	(844)		1,515
Tax benefit related to exercise of stock options	—	—	565	—	—	—		565
Purchase of treasury stock	(1,577)	(1)	—	(31,696)	—	—		(31,697)
Total comprehensive income:								
Net income	—	—	—	—	—	51,094	$ 51,094	51,094
Realized gains on available-for-sale marketable securities	—	—	—	—	(22,908)	—	(22,908)	(22,908)
Unrealized loss from hedging activities, net	—	—	—	—	(72)	—	(72)	(72)
Total comprehensive income							$ 28,114	

* Represents an amount lower than $1.

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

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STATEMENTS OF CHANGES IN STOCKHOLDERS' EQUITY

U.S. dollars in thousands, except share data

	Number of shares of Common stock	Common stock amount	Additional paid-in capital	Treasury stock	Accumulated other comprehensive income	Retained earnings	Total comprehensive income	Total stockholders' equity
Balance at December 31, 2004	$ 27,954	$ 28	$ 187,471	$ (29,797)	$ 65	$ 157,723		$ 315,490
Issuance of treasury stock upon purchase of ESPP shares by employees	74	— *	—	1,493	—	(110)		1,383
Issuance of treasury stock upon exercise of stock options by employees	1,250	1	223	25,895	—	(7,118)		19,001
Tax benefit related to exercise of stock options	—	—	845	—	—	—		845
Purchase of treasury stock	(682)	— *	—	(17,038)	—	—		(17,038)
Total comprehensive income:								
Net income	—	—	—	—	—	29,473	$ 29,473	29,473
Unrealized loss from hedging activities, net	—	—	—	—	(20)	—	(20)	(20)
Total comprehensive income							$ 29,453	
Balance at December 31, 2005	28,596	$ 29	$ 188,539	$ (19,447)	$ 45	$ 179,968		$ 349,134

* Represents an amount lower than $1.

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

DSP GROUP, INC.

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

	Year ended December 31,		
	2005	2004	2003
Cash flows from operating activities:			
Net income	$ 29,473	$ 51,094	$ 25,355
Adjustments required to reconcile net income to net cash provided by operating activities:			
Depreciation	4,599	2,506	3,224
Increase in deferred income taxes, net	(287)	(1,252)	(272)
Capital gains from available-for-sale marketable securities of traded companies	—	(44,448)	(241)
Amortization of intangible assets	1,145	718	379
Impairment of goodwill	—	4,304	—
In-process research and development write-off	—	2,682	2,727
Accrued interest and amortization of premium on held-to- maturity marketable securities and short term investments	2,437	2,321	1,989
Tax benefit related to exercise of stock options	845	565	685
Decrease (increase) in trade receivables	(11,015)	9,868	(10,971)
Decrease (increase) in other accounts receivable and prepaid expenses	509	(826)	27
Increase in inventories	(3,217)	(1,003)	(1,550)
Increase in long-term prepaid expenses and lease deposits	(42)	(115)	(127)
Increase (decrease) in trade payables	4,990	(3,391)	1,972
Increase in accrued compensation and benefits	2,095	421	4,444
Increase (decrease) in income taxes payable	(5,572)	4,608	3,684
Increase (decrease) in accrued expenses and other accounts payable	(739)	(832)	3,075
Increase (decrease) in accrued severance pay, net	(59)	152	125
Other	—	21	(33)
Net cash provided by operating activities	25,162	27,393	34,492
Cash flows from investing activities:			
Purchase of held-to-maturity marketable securities and short-term investments	(105,142)*	(141,173)	(191,882)
Proceeds from maturity of held-to-maturity marketable securities and short-term investments	78,117	108,246	146,395
Purchase of property and equipment	(9,620)	(1,759)	(3,158)
Proceeds from sale of property and equipment	—	—	72
Proceeds from realization of available-for-sale equity securities of traded companies	—	55,456	508
Payment for acquisition of Bermai Inc. assets	—	(5,128)	—
Payment for acquisition of Teleman Multimedia Inc. assets	(1,450)	(1,450)	(2,325)
Cash received from discontinued operations	—	—	4,737
Net cash provided by (used in) investing activities	(38,095)	14,192	(45,653)

* Reclassified

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

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DSP GROUP, INC.

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

	Year ended December 31,		
	2005	**2004**	**2003**
Cash flows from financing activities:			
Issuance of common stock and treasury stock upon exercise of stock options and upon purchase of ESPP	19,604	14,127	24,211
Purchase of treasury stock	(17,038)	(31,697)	(16,157)
Net cash provided by (used in) financing activities	2,566	(17,570)	8,054
Increase (decrease) in cash and cash equivalents	(10,367)	24,015	(3,107)
Cash and cash equivalents at the beginning of the year	60,827	36,812	39,919
Cash and cash equivalents at the end of the year	$ 50,460	$ 60,827	$ 36,812
Non-cash transactions:			
Purchase of property and equipment	$ —	$ —	$ 2,504
Supplemental disclosures of cash flows activities:			
Cash paid during the year for:			
Taxes on income	$ 10,948	$ 17,149	$ 1,202

* Reclassified

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

DSP GROUP, INC.

CONSOLIDATED BALANCE SHEETS
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(amounts in thousands)

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

Acquisition of Bermai Inc. assets

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

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.

DSP GROUP, INC.

CONSOLIDATED BALANCE SHEETS
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

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

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 income 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 the discounted cash flows approach that is a form of the income approach.

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 the "relief from royalty" approach that is a form of income approach. The amount amortized during 2005 and 2004 was $531 and $103, respectively.

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 activities. Teleman 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 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 was 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, on the other hand. In addition, the Company hired 10 engineers who were previously employed by Teleman.

DSP GROUP, INC.

CONSOLIDATED BALANCE SHEETS
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

Based upon an independent valuation of tangible and intangible assets acquired, the Company has allocated the total cost of the acquisition of Teleman's assets 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 $2,727. 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 income 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 the discounted cash flows approach that is a form of income approach.

2. The value assigned to the patents and workforce amounted to $2,455, which will be amortized over a period of 4 years, and was determined based on the "relief from royalty" approach that is a form of the income approach. The amount amortized during 2005, 2004 and 2003 was $614, $614 and $378, respectively.

VoicePump Inc.

VoicePump, Inc. ("VoicePump"), was a wholly-owned subsidiary of the Company, in the U.S. which 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 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 VoIP gateway market and to focus its efforts on VoIP telephony products. As a result of this decision, the Company assessed the carrying value of goodwill associated with VoicePump in accordance with SFAS No. 142. The first step of the goodwill impairment test involved the determination of the fair value of VoicePump using the income approach based on the discounted cash flow model. This evaluation indicated that the carrying amount of VoicePump exceeded its fair value. In accordance with SFAS No. 142, if the carrying amount of a reporting unit exceeds its fair value, the second step of the goodwill impairment test is to measure the amount of the impairment loss. During the second step of the evaluation, the Company allocated the fair value of VoicePump to all of its assets and liabilities (including unrecognized intangible assets) as if VoicePump had been acquired in a business combination. The excess of the fair value of VoicePump over the amounts assigned to its assets and liabilities is the implied fair value of goodwill was estimated to be approximately $1,500. As a result, the Company recorded a charge associated with the impairment of goodwill of VoicePump in the amount of $4,304 in the second quarter of 2004. The expense was included in the Company's operating expenses for year ended December 31, 2004 under "Impairment of goodwill". For a discussion about the impairment test done in 2005, see note 2.

DSP GROUP, INC.

CONSOLIDATED BALANCE SHEETS
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

Concentration of other risks

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

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

NOTE 2: SIGNIFICANT ACCOUNTING POLICIES

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

Use of estimates

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

Financial statements in U.S. dollars

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

Monetary accounts maintained in currencies other than the dollar are remeasured into dollars in accordance with Statement of Financial Accounting Standard No. 52, "Foreign Currency Translations". All transaction gains

and losses resulting from the remeasurement of monetary balance sheet items are reflected in the consolidated statements of income as financial income or expenses as appropriate, and have not been significant to date for all years presented.

Principles of consolidation

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

Cash and Cash equivalents

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

Short-term investments

The Company categorizes auction rate securities as available-for-sale short-term investments in accordance with Statement of Financial Accounting Standard No. 115, "Accounting for Certain Investments in Debt and Equity Securities" ("SFAS No. 115"). Auction rate securities are reported at cost, which approximates fair market value due to the interest rate reset feature of these securities. As such, no unrealized gains or losses related to these securities were recognized during the years ended December 31, 2005 and 2004. See "Reclassifications" in Note 2 for information regarding prior period adjustments to the classification of auction rate securities.

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

Marketable securities

The Company and its subsidiaries account for investments in debt and equity securities in accordance with 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, 2005 and 2004, the Company classified its investment in marketable securities as held to maturity.

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

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:

1. The carrying values of cash and cash equivalents, short-term investments, trade receivables and trade payables approximate fair values due to the short-term maturities of these instruments.

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DSP GROUP, INC.

CONSOLIDATED BALANCE SHEETS
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

2. The carrying value of held to maturity marketable securities is based on amortized cost. The fair value of held-to-maturity securities is based on quoted market price (see Note 3).

3. The fair value of derivative instruments is estimated by obtaining quotes from brokers.

Inventories

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

The Company and its subsidiaries periodically evaluate the quantities on hand relative to current and historical selling prices and historical and projected sales volume. Based on this evaluation, provisions are 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 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	By the shorter of term of the lease or the useful life of the asset

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 “Accounting for the Impairment or Disposal of Long-Lived Assets,” whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. The recoverability of assets to be held and used is measured by a comparison of the carrying amount of such assets to the future undiscounted cash flows expected to be generated by the assets. If such assets are considered to be impaired, the impairment to be recognized is measured by the amount by which the carrying amount of the assets exceeds the fair value of the assets. As of December 31, 2005 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. SFAS No. 142 requires goodwill and indefinite-lived intangible assets to be tested for impairment at least annually or between annual tests if certain events or indicators of impairment occur. The impairment test consists of a comparison of the fair value of an intangible asset with its carrying amount. If the carrying amount of an intangible asset exceeds its fair value, an impairment loss is recognized in an amount equal to that excess. Goodwill is tested for impairment at the reporting unit level by a comparison of the fair value of a reporting unit with its carrying amount.

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

Severance pay

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

The deposited funds include profits accumulated up to the balance sheet date. The deposited funds may be withdrawn only upon the fulfillment of the obligation pursuant to 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. DSP Korea's severance liability has been fully accrued.

Severance expense for the years ended December 31, 2005, 2004 and 2003, was approximately $923, $1,229 and $882, respectively.

Employee benefit plan

The Company has a 401(k) deferred compensation plan covering all employees in the U.S. All eligible employees may elect to contribute up to 75% of their compensation to the plan through salary deferrals, subject to IRS limits. The maximum deferral for calendar year 2005 was $14 ($18 if the employee reached the age of 50 by December 31, 2005). The Company currently offers an employer matching program. This matching contribution currently is 25% of the employee contribution up to a maximum of 1% of the employee's compensation per year. This matching contribution vests 25% per year over the first 4 years of the employee's service to the Company.

Revenue recognition

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

DSP GROUP, INC.

CONSOLIDATED BALANCE SHEETS
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

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

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

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 each 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 1,620,293, 3,963,202 and 1,495,279 shares of common stock for the years ended December 31, 2005, 2004 and 2003, respectively, were not included in the computation of diluted net earnings per share, because option exercise prices were greater than the average market price of the common stock and, therefore, their inclusion would have been anti-dilutive.

Income taxes

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

Concentrations of credit risk

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

The majority of cash and cash equivalents of the Company and its subsidiaries is invested in U.S. dollar deposits 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 the deposits and investments of the Company and its subsidiaries are financially sound and, accordingly, minimal credit risk exists with respect to these deposits and investments.

A majority of the product sales of the Company and its subsidiaries is to distributors who in turn, sell to original equipment manufacturers of consumer electronics products. The customers of the Company and its subsidiaries are located primarily in Japan, Hong Kong, Europe and the United States. The Company and its subsidiaries perform ongoing credit evaluations of their customers. A 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 and short term investments include investments in debentures of U.S. corporations, state and political subdivisions. Management believes that those corporations and state institutions are financially sound, the portfolio is well diversified, and accordingly, that minimal credit risk exists with respect to these marketable securities.

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

Derivative instruments

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

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

To protect against the increase in value of forecasted foreign currency cash 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 12 months with put options and forward contracts.

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

As of December 31, 2005, the Company recorded accumulated other comprehensive income amounting to $45 from its put options and forward contracts with respect to payroll and rent payments expected in 2006. Such amounts will be recorded into earnings in 2006.

The Company recognized net gains (losses) were immaterial during the years ended December 31, 2005, 2004 and 2003 , related to the put options and forward contracts.

Accounting for stock-based compensation

The Company has elected to follow Accounting Principles Board Opinion No. 25, "Accounting for Stock Issued to Employees" ("APB No. 25") and FASB interpretation No. 44, "Accounting for Certain Transactions

DSP GROUP, INC.

CONSOLIDATED BALANCE SHEETS
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

Involving Stock Compensation" ("FIN No. 44") in accounting for its employee stock options plans. Under APB No. 25, when the exercise price of an employee's options equals or is higher than the market price of the 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 at the date of grant using a Black-Scholes option pricing model with the following weighted average assumptions; for employee stock option plans: risk-free interest rates of 3.97%, 3.23% and 2.37% for 2005, 2004 and 2003, respectively; a dividend yield of 0.0% for each of those years; a volatility factor of the expected market price of the common stock of 0.36, 0.38 and 0.44 for 2005, 2004 and 2003, respectively; and a weighted-average expected life of the option of 3.3, 2.9 and 2.9 years for 2005, 2004 and 2003, respectively. for employee stock purchase plan: risk-free interest rates of 4.36%, 3.23% and 2.37% for 2005, 2004 and 2003, respectively; a dividend yield of 0.0% for each of those years; a volatility factor of the expected market price of the common stock of 0.36, 0.38 and 0.44 for 2005, 2004 and 2003, respectively; and a weighted-average expected life of the option of 1.25 years for each of those years.

	Year ended December 31, Weighted average fair value of options grants		
	2005	2004	2003
Exercise price equals market price on date of grants	$ 6.83	$ 6.73	$ 5.58

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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,		
	2005	2004	2003
Net income, as reported	$ 29,473	$ 51,094	$ 25,355
Deduct—stock-based compensation expense determined under fair value method for all awards, net of related tax effects	9,899	10,570	9,338
Pro forma net income	$ 19,574	$ 40,524	$ 16,017
Net earnings per share:			
Basic, as reported	$ 1.04	$ 1.79	$ 0.91
Basic, pro forma	$ 0.69	$ 1.42	$ 0.57
Diluted, as reported	$ 0.99	$ 1.70	$ 0.86
Diluted, pro forma	$ 0.66	$ 1.35	$ 0.54
Net income from continuing operations, as reported	$ 29,473	$ 51,094	$ 25,355
Deduct—stock based compensation expenses related to continuing operations determined under fair value method for all awards, net of related tax effect	9,899	10,308	8,677
Pro forma net income	$ 19,574	$ 40,786	$ 16,678
Net earnings per share:			
Basic, as reported	$ 1.04	$ 1.79	$ 0.91
Basic, pro forma	$ 0.69	$ 1.43	$ 0.59
Diluted, as reported	$ 0.99	$ 1.70	$ 0.86
Diluted, pro forma	$ 0.66	$ 1.36	$ 0.56

Impact of recently issued accounting pronouncements

On December 16, 2004, the FASB issued SFAS No. 123R, “Share-Base Payment” (“FAS 123R”) which revises the previously effective SFAS No. 123 and supersedes APB No. 25. FAS 123R requires all share-based payments to employees, including grants of employee stock options, to be recognized in the financial statements based upon their fair values, beginning with the first interim or annual period after December 15, 2005, with early adoption encouraged.

The Company has the option to choose either the modified prospective or modified retrospective method. The Company expects to adopt FAS 123R in the first quarter of 2006, using the modified prospective method of adoption which requires that compensation expense be recorded over the expected remaining life of all unvested stock options and for any new grants thereof at the beginning of the first quarter of adoption of FAS 123R. The Company is currently evaluating the impact FAS 123R will have on the Company, and based on their preliminary analysis, expect to incur additional compensation expense as a result of the adoption of this new accounting standard that may be material to the 2006 financial statements.

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CONSOLIDATED BALANCE SHEETS
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

Had the Company adopted FAS 123R in prior periods, the impact of that statement would have approximated the impact of FAS 123 as described in the disclosure of pro forma net income and earnings per share of common stock in Note 2 to the consolidated financial statements.

In May 2005, the FASB issued SFAS No. 154 ("SFAS 154"), "Accounting Changes and Error Corrections", a replacement of APB No. 20, "Accounting Changes" and SFAS No. 3, "Reporting Accounting Changes in Interim Financial Statements". SFAS 154 provides guidance on the accounting for and reporting of accounting changes and error corrections. APB No. 20 previously required that most voluntary changes in accounting principles be recognized by including in net income for the period of the change, the cumulative effect of changing to the new accounting principle. SFAS 154 requires retroactive application to prior periods' financial statements of a voluntary change in accounting principles unless it is impracticable. SFAS 154 is effective for accounting changes and corrections of errors made in fiscal years beginning after December 15, 2005. As of December 31, 2005, adoption of SFAS No. 154 will not have a material impact on the Company's financial position or results of operation.

In November 2005, the FASB issued FSP FAS 115-1, "The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments" ("FSP"). The FSP addresses the determination as to when an investment is considered impaired, whether that impairment is other than temporary, and the measurement of an impairment loss. The FSP also includes accounting considerations subsequent to the recognition of other than-temporary impairment and requires certain disclosures about unrealized losses that have not been recognized as other-than-temporary impairments. The guidance in the FSP amends FASB Statements No. 115, "Accounting for Certain Investments in Debt and Equity" ("SFAS No. 115"). The FSP replaces the impairment evaluation guidance of EITF Issue No. 03-1, "The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments," with references to the existing other-than-temporary impairment guidance. The FSP clarifies that an investor should recognize an impairment loss no later than when the impairment is deemed other-than-temporary, even if a decision to sell an impaired security has not been made. The guidance in the FSP is to be applied to reporting periods beginning after December 15, 2005. As of December 31, 2005, the adoption of FSP did not have a material impact on the Company's financial position or results of operation.

Reclassification

Certain prior year amounts have been reclassified to conform to the current-year presentation, including the reclassification of auction rate securities ("ARS") as short-term investments instead of cash and cash equivalents in accordance with guidance issued by the Securities and Exchange Commission. The Company reclassified $11,300 of investments in ARS as of December 31, 2004 that were previously included in cash and cash equivalents as short-term investments. The Company has also made corresponding adjustments to its consolidated statements of cash flows for the year ended December 31, 2004 to reflect the gross purchases and sales of these securities as investing activities rather than as a component of cash and cash equivalents. This change in classification does not affect previously reported cash flows from operations or from financing activities in our previously reported consolidated statements of cash flows, or our previously reported consolidated statements of operations for any periods.

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CONSOLIDATED BALANCE SHEETS
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

NOTE 3: MARKETABLE SECURITIES

The following is a summary of held-to-maturity securities at December 31, 2005 and 2004:

	Amortized cost		Unrealized losses, net		Estimated fair value	
	2005	2004	2005	2004	2005	2004
US government obligations and political subdivisions	$ 164,257	$ 131,999	$ (3,596)	$ (1,582)	$ 160,661	$ 130,417
Corporate obligations	93,446	123,856	(1,416)	(380)	92,030	123,476
	$ 257,703	$ 255,855	$ (5,012)	$ (1,962)	$ 252,691	$ 253,893

The amortized cost of held-to-maturity debt securities at December 31, 2005, by contractual maturities, are shown below:

		Unrealized gains (losses)		
	Amortized cost	Gains	(Losses)	Estimated fair value
Due in one year or less	$ 71,875	$ —	$ (778)	$ 71,097
Due after one year to five years	185,828	—	(4,234)	181,594
	$ 257,703	$ —	$ (5,012)	$ 252,691

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

The unrealized losses in the Company's investments in held-to-maturity marketable securities were caused by interest rate increases. The contractual cash flows of these investments are either guaranteed by the U.S. government or an agency of the U.S. government or were issued by highly rated corporations. Accordingly, it is expected that the securities would not be settled at a price less than the amortized cost of the Company's investment. Based on the immaterial severity of the impairments and the ability and intent of the Company to hold these investments until maturity, the bonds were not considered to be other than temporarily impaired at December 31, 2005.

NOTE 4: INVENTORIES

Inventories are composed of the following:

	December 31,	
	2005	2004
Work-in-progress	$ 7,145	$ 4,571
Finished products	5,541	4,898
	$ 12,686	$ 9,469

DSP GROUP, INC.

CONSOLIDATED BALANCE SHEETS
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

NOTE 5: PROPERTY AND EQUIPMENT

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

	December 31, 2005	December 31, 2004
Cost:		
Computers and peripheral equipment	$ 32,690	$ 24,965
Office furniture and equipment	1,232	954
Motor vehicles	115	154
Leasehold improvements	3,613	1,957
	37,650	28,030
Less—accumulated depreciation	25,946	21,347
Depreciated cost	$ 11,704	$ 6,683

NOTE 6: INVESTMENTS IN EQUITY SECURITIES OF TRADED COMPANIES

(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.*

At June 30, 2002, the 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, "*Other Than Temporary Impairment of Certain Investments in Debt and Equity Securities" ("*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 statement of income for the year 2002.

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

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 of AudioCodes' ordinary shares for gross proceeds of approximately $9,600, resulting in a capital gain of approximately $7,670.

DSP GROUP, INC.

CONSOLIDATED BALANCE SHEETS
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

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

(2) Tomen Corporation:

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

At December 31, 2002, the 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 statement 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

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

	Year ended December 31,	
	2005	2004
Cost:		
Patents	$ 4,009	$ 4,009
Workforce	570	570
	4,579	4,579
Accumulated amortization:		
Patents	1,869	866
Workforce	373	231
	2,242	1,097
Amortized cost	$ 2,337	$ 3,482

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).

b. Amortization expenses amounted to $1,145, $718 and $378 for the year ended December 31, 2005, 2004 and 2003, respectively.

DSP GROUP, INC.

CONSOLIDATED BALANCE SHEETS
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

c. Estimated amortization expenses for the years ended:

Year ended December 31,	
2006	$ 1,145
2007	764
2008	428
	$ 2,337

NOTE 8: STOCKHOLDERS' EQUITY

Preferred stock

The Company's Board of Directors has the authority, without any further vote or action by the stockholders, to provide for the issuance of up to 5,000,000 shares of preferred stock in one or more series with such designations, rights, preferences, and limitations as the Board of Directors may determine, including the consideration received, the number of shares comprising each series, dividend rates, redemption provisions, liquidation preferences, sinking fund provisions, conversion rights and voting rights.

Common stock

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

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

Dividend policy

At December 31, 2005, the Company had retained earnings of $179,968. 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 million shares. In 2005, 2004 and 2003, the Company repurchased 682,000, 1,577,000 and 746,000 shares, respectively, of common stock at an average purchase price of $24.98, $20.09 and $21.66 per share, respectively, for an aggregate purchase price of $17,038, $31,697 and $16,157, respectively. As of December 31, 2005, 3,014,000 shares of common stock remain authorized for repurchase.

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

In 2005, 2004 and 2003, the Company issued 1,324,000, 145,000 and 693,000 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 ("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, 2005, 253,272 shares of common stock are available 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 ("First Option"). Thereafter, each outside director shall automatically be granted an option to purchase 15,000 shares of common stock (a "Subsequent Option") on January 1 of each year if, on such date, he shall have served on the Board of Directors for at least six months. In addition, an option to purchase an additional 15,000 shares of common stock (a "Committee Option") is granted on January 1 of each year to each outside director for each committee of the Board on which he shall have served as a chairperson for at least six months.

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

1998 Non-Officer Employee Stock Option Plan

In 1998, the Company adopted the 1998 Non-Officer Employee Stock Option Plan ("the 1998 Plan"). Under the 1998 Plan, employees may be granted non-qualified stock options for the purchase of common stock. The 1998 Plan expires in 2008 and currently provides for the purchase of up to 5,062,881 shares of common stock. As of December 31, 2005, 169,610 shares of common stock are available for grant under the Directors Plan.

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. As of December 31, 2005, 11,770 shares of common stock are available for grant under the Directors 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. 3,642,040 shares of common stock were reserved for issuance as of December 31, 2005 under this plan. Pursuant to the terms of the 2003 Plan, on the first business day of each calendar year beginning in 2004, the number of shares authorized under the plan increases by an amount equal to three percent of the number of shares of common stock outstanding as of such date or a less number of shares determined by the Company's Board of Directors. As of December 31, 2005, 128,117 shares of common stock are available for grant under the Directors 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 ("ESPP")

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 provides that substantially all employees may use up to 10% of their salaries to purchase stock at 85% of its fair market value on specified dates via payroll deductions. There were approximately 74,000, 70,000, and 52,000 shares issued at a weighted average exercise price of $18.69, $13.61 and $12.40, respectively, under the ESPP in 2005, 2004 and 2003, respectively.

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CONSOLIDATED BALANCE SHEETS
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

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

The number of shares of common stock available for future issuance outstanding at December 31, 2005, is as follows:

	In thousands
Employee stock purchase plan	66
Stock options	575
Undesignated Preferred stock	5,000
	5,641

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

	Year ended December 31,					
	2005		2004		2003	
	Amount of options	Weighted average exercise price	Amount of options	Weighted average exercise price	Amount of options	Weighted average exercise price
	Thousands		Thousands		Thousands	
Options outstanding at beginning of year	7,455	$ 20.91	7,014	$ 20.04	6,308	$ 17.03
Changes during the year:						
Granted	1,257	$ 23.99	1,569	$ 23.41	2,482*	$ 21.68
Exercised	(1,052)	$ 15.63	(760)	$ 15.81	(1,676)*	$ 11.19
Forfeited and cancelled	(338)	$ 23.76	(368)	$ 24.64	(100)*	$ 18.77
Options outstanding at end of year	7,322	$ 22.06	7,455	$ 20.91	7,014	$ 20.04
Options exercisable at end of year	4,395	$ 21.83	3,873	$ 21.03	2,997	$ 21.02

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

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 with Parthus Technologies PLC ("Parthus"). The combined company is currently named CEVA, Inc.

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The following is a summary of activities under the Company's options plans related to the Ceva employees following the separation date:

	Year ended December 31,					
	2005		2004		2003	
	Amount of options	Weighted average exercise price	Amount of options	Weighted average exercise price	Amount of options	Weighted average exercise price
	Thousands		Thousands		Thousands	
Options outstanding at the beginning of the year	546	$ 21.75	657	$ 21.03	1,056	$ 17.96
Changes during the year:						
Exercised	(197)	$ 12.94	(86)	$ 13.53	(386)	$ 12.47
Forfeited and cancelled	(7)	$ 27.21	(25)	$ 31.06	(13)	$ 25.79
Options outstanding at end of year	342	$ 26.74	546	$ 21.75	657	$ 21.03
Options exercisable at end of year	304	$ 26.78	476	$ 21.87	503	$ 20.94

(1) 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 CEVA, 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 CEVA following the separation.

For employees who transferred to CEVA—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 CEVA 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 (i) 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, and (ii) 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%).

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The options outstanding as of December 31, 2005, have been separated into ranges of exercise price as follows:

	Options outstanding			Options exercisable		
Range of exercise price	Outstanding Thousands	Remaining contractual life (years)	Weighted average exercise price	Exercisable Thousands	Remaining contractual life (years)	Weighted average exercise price
$ 7.46 – 10.87	86	0.4	$ 7.54	86	0.4	$ 7.54
$11.48 – 17.14	1,500	3.4	$ 14.46	1,204	3.3	$ 14.48
$17.39 – 25.99	4,467	5.1	$ 22.43	1,968	4.2	$ 21.52
$26.20 – 42.73	1,610	1.9	$ 29.90	1,441	1.6	$ 30.27
	7,663	4.1	$ 20.96	4,699	3.1	$ 22.15

NOTE 9: MAJOR CUSTOMERS AND GEOGRAPHIC INFORMATION

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

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

	Year ended December 31,		
	2005	2004	2003
Revenue distribution:			
United States	$ 1,101	$ 1,238	$ 1,302
Japan	141,310	119,052	119,355
Europe	699	1,831	3,063
Hong-Kong	33,521	27,700	21,624
Other	10,594	7,690	7,531
	$ 187,225	$ 157,511	$ 152,875

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

	December 31,		
	2005	2004	2003
Long-lived assets:			
United States	$ 4,552	$ 4,270	$ 6,321
Israel	8,357	5,563	6,215
Other	1,142	1,832	2,452
	$ 14,051	$ 11,665	$ 14,988

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The following is a summary of revenues from major customers:

	Year ended December 31,		
	2005	2004	2003
		%	
Customer A*	49%	51%	58%
Customer B*	18%	20%	18%
Customer C	13%	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 Herzliya Pituach, Israel and in California. The lease agreement for the Israeli facilities is effective until November 2008. The Company has various agreements for its facilities in the U.S. terminating in 2007-2009. 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 2007. The Company has operating lease agreements for its motor vehicles, which terminate in 2006 to 2008.

a. At December 31, 2005, the Company is required to make the following minimum lease payments under non-cancelable operating leases for its motor vehicles and facilities:

Year ended December 31,	
2006	$ 2,907
2007	1,835
2008	1,212
2009	159
	$ 6,113

b. The Company has committed to enter into financial lease agreement with its assembly and testing subcontractor upon which it will purchase approximately 3.5 million dollars worth of equipment to support its capacity needs.

Claims

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

b. From time to time, the Company may become involved in litigation relating to claims arising in the ordinary course of business activities. Also, as is typical in the semiconductor industry, the Company has been and 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

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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 currently believes that there are no claims or actions pending or threatened against it, the ultimate disposition of which would have a material adverse effect on the Company.

NOTE 11: TAXES ON INCOME

a. The provision for income taxes is as follows:

	Year ended December 31,		
	2005	2004	2003
Domestic taxes:			
Federal taxes:			
Current	$ 1,157	$ 15,637	$ 2,259
Deferred	(164)	(2,929)	(82)
	993	12,708	2,177
State taxes:			
Current	(30)	1,159	33
Deferred	68	(132)	(10)
	38	1,027	23
Foreign taxes:			
Current	5,196	7,679	3,447
Deferred	(190)	68	(272)
	5,006	7,747	3,175
Taxes on income	$ 6,037	$ 21,482	$ 5,375

The tax benefits associated with the exercise of non qualified stock options reduced taxes currently payable by $845 in 2005, $565 in 2004 and $685 in 2003. Such benefits were credited to additional paid-in capital.

b. Income before taxes is comprised as follows:

	Year ended December 31,		
	2005	2004	2003
Domestic	$ 5,030	$ 47,461	$ 5,155
Foreign	30,480	25,115	25,575
	$ 35,510	$ 72,576	$ 30,730

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

	Year ended December 31,		
	2005	2004	2003
Income before taxes on income	$ 35,510	$ 72,576	$ 30,730
Theoretical tax at U.S. statutory tax rate (35%)	$ 12,428	$ 25,402	$ 10,756
State taxes, net of federal benefit	25	667	16
Goodwill impairment	—	1,506	—
Foreign income taxed at rates other than U.S. rate	(5,662)	(5,514)	(5,785)
Other individually immaterial items	(754)	(579)	388
	$ 6,037	$ 21,482	$ 5,375

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

	December 31,	
	2005	2004
Deferred tax assets (short-term):		
Reserves and accruals	$ 1,227	$ 1,168
Total deferred tax assets (short-term)	1,227	1,168
Deferred tax assets (long-term):		
Intangible assets	1,205	1,208
Other	433	202
Total deferred tax assets (long-term)	1,638	1,410
Total deferred tax assets	$ 2,865	$ 2,578

Management believes that the deferred 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 $62,652 of the undistributed earnings of DSP Group Israel. The Company intends to invest these earnings indefinitely in operations outside the U.S.

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

DSP Group Israel's production facilities have been granted "Approved Enterprise" status under Israeli law in connection with six separate investment plans.

According to the provisions of such Israeli law, DSP Group Israel has chosen to enjoy the "alternative benefits track" which is a waiver of grants in return for a tax exemption. Accordingly, DSP Group Israel's income from an "Approved Enterprise" is tax-exempt for a period of two or four years and is subject to a reduced corporate tax rate of 10%-25% (based on the percentage of foreign ownership) for an additional period of eight or six years, respectively. The tax benefits under these investment plans are scheduled to gradually expire by 2017.

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

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

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

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, 2005, 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 by share capital.

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

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

As of December 31, 2005, approximately $22,501 was derived from tax exempt profits earned by DSP Group Israel's "Approved Enterprises". The Company's board of directors has determined that such tax-exempt income will not be distributed as dividends and intend to reinvest the amount of its tax exempt income. Accordingly, no deferred income taxes have been provided on income attributable to DSP Group Israel's "Approved Enterprise" as the undistributed tax exempt income is essentially permanent in duration.

If the retained tax-exempt income is distributed in a manner other than 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 $2,250 would be incurred as of December 31, 2005.

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

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

On April 1, 2005, an amendment to the Investment Law came into effect ("the Amendment") and has significantly changed the provisions of the Investment Law. The Amendment limits the scope of enterprises which may be approved by the Investment Center by setting criteria for the approval of a facility as an Approved Enterprise, such as provisions generally requiring that at least 25% of the Approved Enterprise's income will be

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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 certificate of approval already granted will remain subject to the provisions of the law as they were on the date of such approval. Therefore DSP Group Israel 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 and the Company may be required to record deferred tax liability with respect to such tax-exempt income. As of December 31, 2005, the Company did not generate income under the provision of the new law.

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

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

g. Reduction in Israeli tax rate:

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

NOTE 12: NET EARNINGS PER SHARE

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

	Year ended December 31,		
	2005	2004	2003
Numerator:			
Net income	$ 29,473	$ 51,094	$ 25,355
Denominator:			
Weighted average number of shares of common stock outstanding during the year used to compute basic net earnings per share (in thousands)	28,435	27,959	27,912
Incremental shares attributable to exercise of outstanding options (assuming proceeds would be used to purchase treasury stock) (in thousands)	1,408	1,133	1,681
Weighted average number of shares of common stock used to compute diluted net earnings per share (in thousands)	29,843	29,092	29,593
Basic net earnings per share	$ 1.04	$ 1.79	$ 0.91
Diluted net earnings per share	$ 0.99	$ 1.70	$ 0.86