NICE SYSTEMS LTD
Form F-3/A
December 23, 2003
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As filed with the Securities and Exchange Commission on December 23, 2003

Registration No. 333-109766

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

Amendment No. 1 to

FORM F-3

REGISTRATION STATEMENT

UNDER

THE SECURITIES ACT OF 1933

NICE SYSTEMS LTD.

(Exact name of Registrant as specified in its charter and translation of Registrant s name into English)

Israel **(State or other jurisdiction** **of incorporation or organization)**	**N/A** **(I.R.S. Employer** **Identification No.)**
NICE Systems Ltd.	**NICE Systems Inc.**
8 Hapnina Street	**301 Route 17 North**
P.O. Box 690	**10th Floor**
43107 Ra anana	**Rutherford, New Jersey 07070**

Israel

Tel: 972-9-775-3777

Fax: 972-9-743-4282

(Address and telephone number of Registrant s principal executive offices)

Tel: 201-964-2600

Fax: 201-964-2610

(Name, address, and telephone number of agent for service)

Copies of all communications, including communications sent to the agent for service, to:

David M. Warburg, Esq.

Brown Raysman Millstein Felder & Steiner LLP

900 Third Avenue

New York, New York 10022

Tel: 212-895-2240

Fax: 212-895-2900

Gene Kleinhendler, Esq.

Gross, Kleinhendler, Hodak, Halevy, Greenberg & Co.

1 Azrieli Center

Tel Aviv 67021

Israel

Tel: 972-3-607-4446

Fax: 972-3-607-4433

Approximate date of commencement of proposed sale to the public: As soon as practicable after the effective date of this Registration Statement.

If the only securities being registered on this Form are to be offered pursuant to dividend or interest reinvestment plans, please check the following box. ¨

If any of the securities being registered on this Form are to be offered on a delayed or continuous basis pursuant to Rule 415 under the Securities Act of 1933 as amended (the Securities Act), check the following box. x

If this Form is filed to register additional securities for an offering pursuant to Rule 462(b) under the Securities Act, please check the following box and list the Securities Act registration statement number of the earlier effective registration statement for the same offering. ¨______

If this Form is a post-effective amendment pursuant to Rule 462(c) under the Securities Act, check the following box and list the Securities Act registration statement number of the earlier effective registration statement for the same offering. ¨______

If delivery of the prospectus is expected to be made pursuant to Rule 434, please check the following box. ¨

CALCULATION OF REGISTRATION FEE

Title of each class of securities to be registered	Amount to be Registered	Proposed Maximum Offering Price Per Share(3)	Proposed Maximum Aggregate Offering Price(3)	Amount of Registration Fee
Ordinary shares, par value NIS 1.00 per share (1)	2,016,100 shares(2)	$23.33	$47,035,613	$3,805.18(4)

(1) Represented by American Depositary Shares (ADSs). Each ADS represents one Ordinary Share.

(2) The number of shares to be registered under the Company s initial Form F-3 filed with the Commission on October 17, 2003 was 2,187,500. Since such date, the selling shareholder has sold 171,400 shares pursuant to Rule 144 promulgated under the Securities Act of 1933.

(3) Calculated solely for the purpose of determining the registration fee pursuant to Rule 457(c) under the Securities Act, based upon the average of the high and low prices of the ADSs as quoted on The Nasdaq National Market on December 16, 2003.

(4) $3,519.91 was previously paid with the initial filing of the Form F-3.

The Registrant hereby amends this Registration Statement on such date or dates as may be necessary to delay its effective date until the Registrant shall file a further amendment which specifically states that this Registration Statement shall thereafter become effective in accordance with Section 8(a) of the Securities Act of 1933 or until this Registration Statement shall become effective on such date as the Commission, acting pursuant to said Section 8(a), may determine.

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The information in this prospectus is not complete and may be changed. The selling shareholder named in this prospectus may not sell these securities until the Registration Statement filed with the Securities and Exchange Commission is effective. This prospectus is not an offer to sell these securities and the selling shareholder named in this prospectus is not soliciting offers to buy these securities in any jurisdiction where the offer or sale is not permitted.

Subject to Completion, dated December 23, 2003

PROSPECTUS

NICE SYSTEMS LTD.

2,016,100 American Depositary Shares

Representing 2,016,100 Ordinary Shares

This prospectus relates to the resale to the public, if any, that may be made from time to time by the selling shareholder named in this prospectus of up to 2,016,100 American Depositary Shares of NICE Systems Ltd. The 2,016,100 shares were issued to the selling shareholder in connection with our acquisition of Thales Contact Solutions in November 2002.

The selling shareholder will receive all of the proceeds from the sale of the shares. We will not receive any of the proceeds from the sale of the shares.

Our American Depositary Shares, or ADSs, each of which represents one ordinary share, are quoted on The Nasdaq National Market under the symbol NICE. Our ordinary shares are traded on the Tel-Aviv Stock Exchange. On December 22, 2003, the last reported sale price of our ADSs on The Nasdaq National Market was $23.50 per ADS. On the same date, the last reported price for our ordinary shares on the Tel-Aviv Stock Exchange was NIS 101.80 per share (or $23.33).

Investing in our ordinary shares involves significant risks. See Risk Factors beginning on page 22.

Neither the Securities and Exchange Commission nor any state securities commission in the United States has approved or disapproved of these securities or passed upon the adequacy or accuracy of this prospectus. Any representation to the contrary is a criminal offense.

The Company and the Selling Shareholder have received an exemption from the obligation to publish this prospectus in the manner required pursuant to the prevailing laws of the State of Israel. Nothing in such exemption of the Securities Authority of the State of Israel shall be construed as authenticating the matters contained in this prospectus or as an approval of their reliability or adequacy or an expression of opinion as to the quality of the securities hereby offered.

The date of this prospectus is ______, ____

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You should rely only on the information incorporated by reference or provided in this prospectus or any supplement. We have not authorized anyone else to provide you with different information. This prospectus is not an offer to sell or a solicitation of an offer to buy any securities in any state or jurisdiction where the offer is not permitted. The information contained in this prospectus is accurate only as of its date, and you should not assume that the information in this prospectus or any supplement is accurate as of any other date.

WHERE YOU CAN FIND MORE INFORMATION

We are subject to the information reporting requirements of the Securities Exchange Act of 1934 (which we refer to as the Exchange Act) as a foreign private issuer as defined in Rule 3b-4 of the Exchange Act. In accordance with these reporting requirements, we file reports and other information with the Securities and Exchange Commission (the Commission). Such reports and other information can be inspected and copied at the Public Reference Room of the Commission, 450 Fifth Street, N.W., Washington, D.C. 20549 and at the Commission s regional offices at 500 West Madison Street, Suite 1400, Chicago, IL 60661-2511 and 233 Broadway, New York, New York 10279, at prescribed rates. The Commission also maintains a web site that contains reports, proxy and information statements and other information regarding registrants, such as ourselves, that file electronically with the Commission. The address of this web site is http://www.sec.gov. You may also obtain information from the Public Reference Room by calling the Commission at 1-800-SEC-0330. In addition, our ADSs are quoted on The Nasdaq National Market, so our reports and other information can be inspected at the offices of the National Association of Securities Dealers, Inc. at 1735 K Street, N.W., Washington, D.C. 20006.

We have filed with the Commission a Registration Statement on Form F-3 under the Securities Act of 1933 (which we refer to as the Securities Act) with respect to the shares being offered hereby. This prospectus is part of the Registration Statement and does not contain all the information set forth in the Registration Statement, certain portions of which have been omitted in accordance with the rules and regulations of the Commission. For further information, reference is hereby made to the Registration Statement and the documents incorporated herein by reference. Such additional information may be obtained from the Commission s principal office in Washington, D.C. Statements made in this prospectus as to the contents of any contract, agreement or other document referred to are not necessarily complete and, with respect to each such contract, agreement or other document filed as an exhibit to the Registration Statement, reference is made to the exhibit for more complete description of the matter involved, and each such statement is deemed qualified in its entirety by such reference. We are currently

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exempt from the rules and regulations under the Exchange Act prescribing the furnishing and content of proxy statements, and our officers, directors and principal shareholders are exempt from the reporting and short-swing profit recovery provisions contained in Section 16 of the Exchange Act. Under the Exchange Act, we are not required to publish financial statements as frequently, as promptly or containing the same information as United States companies. We intend to furnish our security holders with annual reports containing financial statements and a report thereon by independent certified public accountants prior to each of our annual meetings.

INCORPORATION OF DOCUMENTS BY REFERENCE

The Securities and Exchange Commission allows us to incorporate by reference information into this prospectus. This means that we can disclose important information to you by referring you to another document filed by us with the Commission. Information incorporated by reference is deemed to be part of this prospectus, except for any information superseded by this prospectus.

The following documents are incorporated herein by reference:

(a) Our Annual Report on Form 20-F for the fiscal year ended December 31, 2002, filed with the Commission on June 26, 2003.

(b) Our Current Reports on Form 6-K filed with the Commission on May 14, 2003; July 30, 2003; October 29, 2003; November 12, 2003; December 3, 2003; December 9, 2003 and December 11, 2003.

(c) The description of our ordinary shares contained in the Registration Statement on Form F-3 filed with the Commission on July 16, 1997 and including any subsequent amendment or report filed for the purpose of updating such description.

In addition, all documents we subsequently file under Sections 13(a), 13(c) and 15(d) of the Exchange Act before the termination of this offering are incorporated by reference in this prospectus from the date they are filed.

We will provide without charge to any person (including any beneficial owner) to whom this prospectus has been delivered, upon the oral or written request of such person a copy of any document incorporated by reference in the Registration Statement (not including exhibits to the information that is incorporated by reference unless such exhibits are specifically incorporated by reference into the information that the Registration Statement incorporates), of which this prospectus forms a part. Such requests should be directed to Lauri A. Hanover, Chief Financial Officer, at NICE Systems Ltd. 8 Hapnina Street, P.O. Box 690 Ra anana, Israel. Our telephone number is 972-9-775-3777. Our corporate web site address is http://www.nice.com. The information on our web site is not intended to be a part of this prospectus.

SPECIAL NOTE REGARDING FORWARD-LOOKING STATEMENTS

This prospectus, and the other reports we have filed and may file from time to time with the Securities and Exchange Commission contain forward-looking statements. These statements involve known and unknown risks, uncertainties and other factors that may cause our actual results, levels of activity, performance, or achievements to be materially different from any future results, levels of activity, performance, or achievements expressed or implied by the forward-looking statements.

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In some cases, you can identify forward-looking statements by terminology such as may, will, should, could, expects, plans, anticipates, believes, estimates, predicts, potential, or continue or the negative of the terms or other comparable terminology.

Although we believe that the expectations reflected in the forward-looking statements are reasonable, we cannot guarantee future results, levels of activity, performance, or achievements. Moreover, neither we nor any other person assumes responsibility for the accuracy and completeness of the statements. We are under no duty to update any of the forward-looking statements after the date of this prospectus.

In this prospectus, unless the context requires otherwise, all references to the Company, NICE or we include NICE Systems Ltd. and its wholly-owned subsidiaries, NICE Systems Inc., NICE Systems GmbH, NICE Systems Canada Ltd., NICE CTI Systems UK Ltd., STS Software Systems (1993) Ltd., NiceEye BV, NICE Systems S.A.R.L, NICE APAC Ltd., NiceEye Ltd. and Racal Recorders Ltd.

For information regarding enforceability of civil liabilities against us and our officers and directors, see Risk Factors - Risks Relating to Israel - Service and enforcement of legal process on us and our directors and officers may be difficult to obtain.

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PROSPECTUS SUMMARY

Our Company

We are an Israeli company founded in 1986. We develop, market and support integrated, scalable multimedia digital recording platforms, enhanced software applications and related professional services. These solutions capture and analyze unstructured (non-transaction) data, and convert it into actionable knowledge for business and security performance management applications. Our solutions capture multiple forms of interaction, including voice, fax, email, web chat, radio, and video transmissions over wireline, wireless, packet telephony, terrestrial trunk radio and data networks. The markets from which we currently derive the majority of our revenues and expect to continue to do so in the future are highly competitive.

Our products are based on two types of recording platforms - audio and video - and are used primarily in contact centers, trading floors, public safety organizations, transportation, corporate security, gaming and correctional facilities as well as various government and intelligence agencies.

We serve the business needs of multiple markets, primarily customer contact centers (formerly called call centers, and more recently called customer interaction centers), financial institutions and trading floors, air traffic control sites, public safety command and control centers, closed circuit television (CCTV) security monitoring installations and government agencies. We believe that we have established a leading position in the high-end customer contact center and financial institutions markets. We intend to continue to leverage our technological leadership, market know-how, channels and partners to provide a full range of recording, quality management and performance management solutions for the contact center and enterprise business intelligence market, which we believe represents significant growth opportunities.

We believe that we are among the leaders in the public safety markets, and are one of the leading vendors in the CCTV security market. In addition, through the acquisition of Thales Contact Solutions which we completed in November 2002, we are able to provide first responders and air traffic control organizations with a full range of recording products. We intend to continue to leverage our technological leadership, market know-how, channels and partners to provide a specific solutions for the air traffic control, public safety, and CCTV security markets, which we believe represent significant growth opportunities.

We provide communication intelligence systems that are used primarily by government agencies to detect, identify, locate, monitor and record transmissions from a variety of sources. We also provide telecommunications monitoring solutions to government law enforcement agencies, which enable them to monitor intercepted target telecommunications.

Our customers in the financial institutions market include ABN AMRO Bank, Chase Manhattan Bank, Citibank, Deutsche Bank, Dresdner Bank, First Chicago NBD, CIBC Oppenheimer, Bank of America, the Sydney Futures Exchange and many others.

Our customers in the contact center market include, among others, Arch Communications, Boston Communications, British Gas, Electric Insurance Company, Halifax Direct, TeleTech Holdings, Thomas Cook, Vodafone Connect and Yorkshire Electricity and many others.

Customers for our CCTV products, which provide continuous video surveillance and recording for security protection purposes, include the Bank of England, Dell Computer Corporation, Atlanta Hartsfield International Airport, Toronto Pearson International Airport, the Helsinki Railway Station -

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Finland, Casino Cosmopol in Sweden, the Metropolitan Nashville Airport Authority, correctional facilities in Brooklyn, New York, and Rush City, Minnesota, Wycombe District Council and Dulwich College - UK and one of California s largest gaming facilities, the Palace Indian Gaming Center of Lemoore.

Our customers in the air traffic control, or ATC, market include the Federal Aviation Administration in the U.S. and ATC authorities in Austria, Canada, China, Croatia, Cyprus, Finland, Germany, Hong Kong, Hungary, Kazakhstan, Iceland, Israel, Japan, the Maldive Islands, the Netherlands, Norway, Poland, Romania, Switzerland, Turkey and others.

Our customers in the public safety market include, among others, the New York City Police Department, Los Angeles Police Department, Chicago Police Department, Indiana State Police, New Jersey State Police, Seattle Fire Department, US Department of Defense, Hampshire Police UK and Hertfordshire Police UK.

Our Offices

Our principal executive offices are located in Ra anana Israel and our U.S. headquarters are located in New Jersey. Following are the mailing addresses for each of these offices.

Principal Executive Offices:	**U.S. Headquarters:**
8 Hapnina Street P.O. Box 690 43107 Ra anana Israel Telephone: 972-9-775-3777 Facsimile: 972-9-743-4282	301 Route 17 North 10th Floor Rutherford, New Jersey 07070 Telephone: 201-964-2600 Facsimile: 201-964-2610

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RECENT OPERATING RESULTS

The following discussion should be read in conjunction with the unaudited condensed financial statements and notes thereto beginning on page F-2 of this Prospectus and the audited consolidated financial statements and notes thereto and Management s Discussion and Analysis in our Annual Report on Form 20-F for the fiscal year ended December 31, 2002, filed with the Commission on June 26, 2003 and incorporated by reference herein.

Forward-looking Statements

We may from time to time make written or oral forward-looking statements, including in filings with the United States Securities and Exchange Commission, in reports to shareholders and in press releases and investor webcasts. You can identify these forward-looking statements by use of words such as strategy , expects , continues , plans , anticipates , believes , will , estimates , intends , projects , goals , targets , a similar meaning. You can also identify them by the fact that they do not relate strictly to historical or current facts.

We cannot assure you that any forward-looking statement will be realized, although we believe we have been prudent in our plans and assumptions. Achievement of future results is subject to risks, uncertainties and inaccurate assumptions. Should known or unknown risks or uncertainties materialize, or should underlying assumptions prove inaccurate, actual results could vary materially from those anticipated, estimated or projected. Investors should bear this in mind as they consider forward-looking statements and whether to invest or remain invested in NICE Systems Ltd. s securities. The forward-looking statements relate to, among other things: operating results; anticipated cash flows; gross margins; adequacy of resources to fund operations; our ability to maintain our average selling prices despite the aggressive marketing and pricing strategies of our competitors; our ability to maintain and develop profitable relationships with our key distribution partners, one of which constitutes more than 20% of our revenues, and the financial strength of our key distribution partners.

In connection with the safe harbor provisions of the Private Securities Litigation Reform Act of 1995, we are identifying important factors that, individually or in the aggregate, could cause actual results and outcomes to differ materially from those contained in any forward-looking statements made by us; any such statement is qualified by reference to the following cautionary statements. Please read the section below entitled Factors That May Affect Future Results to review conditions that we believe could cause actual results to differ materially from those contemplated by the forward-looking statements. You should understand that it is not possible to predict or identify all risk factors. Consequently, you should not consider the following to be a complete discussion of all potential risks or uncertainties. Readers are cautioned not to place undue reliance on these forward-looking statements, which reflect our view only as of the date of this report. Except as required by law, we undertake no obligation to update these forward-looking statements to reflect future events or circumstances or the occurrence of unanticipated events.

Overview

We develop, market and support integrated, scalable multimedia digital recording platforms, enhanced software applications and related professional services. These solutions capture and analyze unstructured (non-transaction) data, and convert it into actionable knowledge for business and security performance management applications. Our solutions capture multiple forms of interaction, including voice, fax, email, web chat, radio, and video transmissions over wireline, wireless, packet telephony, terrestrial trunk radio and data networks. The markets from which we currently derive the majority of our revenues and expect to continue to do so in the future are highly competitive.

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Our products are based on two types of recording platforms, audio and video, and are used primarily in contact centers, trading floors, public safety organizations, transportation, corporate security, gaming and correctional facilities as well as various government and intelligence agencies.

Our development efforts for our recording platforms are aimed at addressing several trends we see developing in the industry. The trend towards the proliferation of voice over IP-based networks is leading to a greater requirement for Voice over Internet Protocol (VOIP) recording capabilities in financial trading, contact centers and public safety environments. The continued trend towards replacing analog video recording with digital video recording is leading to the need for network applications in the video recording area.

We also see the continuation of a trend towards requirements for multimedia recording capabilities, particularly in contact centers (voice, fax, email, chat, screen) and public safety (voice, radio, video, data) markets. We are beginning to see this same trend developing in the financial trading sector, and we expect some Homeland Security initiatives in areas such as border control, critical infrastructure security, first responder communications and lawful interception to require multimedia capture platforms as well.

Our software applications enable our customers to capture, store, retrieve and analyze unstructured data (multimedia interactions) and combine them with data from other systems to create actionable knowledge that can be distributed via reports and alerts to all relevant parties to improve performance.

There is growing demand from our customers for software applications that will leverage the wealth of unstructured data captured by the recording platform to improve overall performance. In turn, as these enhanced software applications are being added, customers are considering our systems mission critical . We see an opportunity for more content analysis applications in contact centers for quality monitoring and contact center management as well as for enterprise-wide process improvement and business performance management. We see a trend towards more software applications in financial trading environment for compliance monitoring and dispute management to improve business performance. We see similar trends happening in digital video recording. We expect video content analysis applications to become increasingly important to building, campus, city center, and infrastructure perimeter security, loss prevention in casinos, retail and warehousing, as well as various homeland security applications to enable proactive security management.

We expect to see an increase in the demand for VOIP recording products, networked video security solutions, and multimedia recording solutions as well as to increase the proportion of software in our product revenue mix and gradually increase the amount of professional services and maintenance revenue.

Our products are sold primarily through a global network of distributors, system integrators and strategic partners; a portion of product sales and most services are sold directly to end-users. One distributor accounted for approximately 22% and 24% of revenues for the first six months of 2003 and 2002, respectively.

Acquisitions

We have consummated three acquisitions during the past three years. These acquisitions were accounted for as purchases, and, accordingly, the purchase price for each acquisition was allocated to the assets acquired and liabilities assumed based on their respective fair values. The results of operations

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related to each acquisition are included in our consolidated statement of operations from the date of acquisition. The following are details for each of these acquisitions:

In November 2002, we consummated an agreement to acquire certain assets and liabilities of Thales Contact Solutions (or TCS), a developer of customer-facing technology for public safety, financial trading and customer contact centers, based in the United Kingdom. TCS was a unit of Thales Group, one of Europe s premier electronics companies. In connection with the acquisition, we paid an initial $29.9 million in cash and issued 2,187,500 ordinary shares to Thales Group at a fair market value of $18.1 million calculated at the date of closing. As a result, Thales Group holds approximately 14% of our shares and two Thales Group executives were elected to our Board of Directors.

Under the terms of the agreement, the cash portion of the purchase price was subject to downward adjustment based on the value of net assets at closing and the full year 2002 sales of TCS. Based on the actual value of net assets acquired and 2002 sales of TCS, we reduced the cash portion of the purchase price as of December 31, 2002 by $12.8 million. This amount is presented on our balance sheet as a Related Party Receivable. Thus, the adjusted purchase price paid, including $4.5 million of capitalized acquisition costs, was recorded as $39.7 million. Of the $12.8 million adjustment referred to above, Thales Group paid us $6.6 million in March 2003. Thales Group disputed the net asset value at closing and the matter was submitted in September 2003 to binding arbitration by an Independent Accountant, in accordance with the terms of the acquisition agreement. Should the Independent Accountant determine a higher net asset value at closing than the actual value of net assets acquired, the additional amount will increase the purchase price and accordingly, additional goodwill will be recorded.

Also under the terms of the agreement, contingent cash payments of up to $10 million in 2003, $7.5 million in 2004, and $7.5 million in 2005 would be due if certain financial performance criteria are met as part of a three-year earn-out provision related to the sale of a particular product in 2002 through 2004. The relevant criteria for 2002 were not met and therefore no contingent payment in respect of 2002 was recorded. Should any contingent payments be made under the agreement in the future, the additional consideration when determinable will increase the purchase price and accordingly additional goodwill will be recorded.

In the fourth quarter of 2002, we recorded a current liability of $2.8 million and a long-term liability of $13.5 million reflecting obligations under a long-term contract assumed by us in the TCS acquisition. In the second quarter of 2003 we completed negotiations to terminate this contract as of November 2004 and amend the terms in the interim. Under the terms of the amended contract, TCS acquisition goodwill was reduced by $5.2 million. Accordingly, we increased the current liability to $7.7 million and decreased the long-term liability to $3.4 million, as at June 30, 2003.

On December 5, 2000, we completed the acquisition of certain assets and liabilities of Stevens Communications Inc. (SCI). SCI is a systems distributor, whose activities included the promotion, distribution, installation and maintenance of our audio recording products and related software applications in North America. We paid $7.0 million in cash and issued 426,745 ADSs of which 186,818 were deemed target shares contingent upon the achievement of certain objectives and events through 2002 and 38,914 ADSs were allotted for the benefit of certain SCI employees subject

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to vesting based on continued employment with us. The contingent target shares were released to SCI upon agreement as to the achievement of the determined objectives.

In October 2001, we entered into a final settlement agreement with SCI addressing a dispute with SCI regarding the fair value of the working capital acquired. The terms of the final settlement resulted in a charge to Other Expense, Net of $4.4 million representing settlement of disputed items of $3.6 million and obligations for future consulting services, which were no longer of value to us.

In April 2000, we acquired all of the outstanding capital stock of Centerpoint Solutions Inc. (CPS) for $3 million in cash and the issuance of 200,000 ADSs of which 50,000 were deemed target shares contingent upon the achievement of certain objectives, which were not met. CPS is a developer of internet-based applications for statistical monitoring, digital recording and automatic customer surveys for contact centers.

In November 2002, we entered into a settlement agreement with Doug Chapiewski, the sole shareholder of CPS, in respect of allegations of misrepresentation, breach of contract and securities fraud in connection with the acquisition of CPS. The terms of the settlement agreement, which included 50,000 shares, resulted in a charge to Other Expense, Net of $3.5 million.

Critical Accounting Policies

Our discussion and analysis of our financial condition and results of operations are based on our consolidated financial statements, which have been prepared in accordance with generally accepted accounting principles in the United States. Our significant accounting principles are presented within Note 2 to our Consolidated Financial Statements. While all the accounting policies impact the financial statements, certain policies may be viewed to be critical. These policies are those that are both most important to the portrayal of our financial condition and results of operations and require our management s most difficult, subjective and complex judgments and estimates. Actual results could differ from those estimates.

Management believes that the significant accounting policies which affect its more significant judgments and estimates used in the preparation of the consolidated financial statements and are the most critical to aid in fully understanding and evaluating our reported results include the following:

Revenue recognition

Allowance for doubtful accounts

Inventory valuation

Impairment of long-lived assets

Deferred income taxes

Contingencies

Restructuring expenses

Revenues. We derive our revenue primarily from two sources: product revenues, which include hardware and software, and service revenues, which include, support and maintenance, installation, consulting and training revenue. Revenue related to sales of our products is generally recognized when persuasive evidence of an agreement exists; the product has been delivered and title and risk of loss have

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passed to the buyer; the sales price is fixed and determinable, no further obligations exist, and collectibility is probable. Sales agreements with specific acceptance terms are not recognized until the customer has confirmed that the product or service has been accepted.

Revenues from fixed-price contracts that require significant customization are recognized using the percentage-of-completion method on the basis of value added and results achieved out of the completeness of the product as a whole or of the total costs estimated to complete the project as a percentage of the costs incurred to date and the estimated costs to complete.

Revenues from maintenance and professional services are recognized ratably over the contract period or as services are performed.

When transactions involve multiple elements, revenue is allocated to the elements based on Vendor Specific Objective Evidence (VSOE) of the relative fair values of each element in the arrangement, according to the residual method. Our VSOE used to allocate the sales price to support services and maintenance is based on the renewal price.

To assess the probability of collection for revenue recognition, we have an established credit policy that determines, by way of mathematical formulae based on the customers financial statements and payment history, the level of open account that is deemed probably collectible for each customer. These credit limits are reviewed and revised periodically on the basis of new customer financial statement information and payment performance.

We record a provision for estimated sales returns and allowances on product sales in the same period as the related revenues are recorded. We base these estimates on the historical sales returns ratio and other known factors. Actual returns could be different from our estimates and current provisions for sales returns and allowances may need to be increased.

Allowance for Doubtful Accounts. We evaluate the collectibility of our accounts receivable based on a combination of factors. In circumstances where we are aware of a specific customer s inability to meet its financial obligations to us, we record a specific allowance against amounts due to reduce the net recognized receivable to the amount we reasonably believe will be collected. For all other customers, we recognize allowances for doubtful accounts based on the length of time the receivables are past due. Insured balances are not reserved. If the financial condition of one of our significant customers or our customers in general should deteriorate, our revenue growth may be limited and additional allowances may be required.

Inventory valuation. At each balance sheet date, we evaluate our inventory balance for excess quantities and obsolescence. This evaluation includes analyses of sales levels by product line and projections of future demand. In addition, we write off inventories that are considered obsolete. Remaining inventory balances are adjusted to the lower of cost or market value. If future demand or market conditions are less favorable than our projections, additional inventory write-downs may be required and would be reflected in cost of sales in the period the revision is made.

During 2002 we completed the outsourcing of the manufacture of our audio and video product platforms. Under this arrangement, we take ownership of inventories at the conclusion of the manufacturing process, such inventories representing finished goods or spare parts. As we largely manufacture to order, we do not tend to accumulate finished goods. We are, however, liable to purchase above a certain level, which is based on historical level of orders to the contract manufacturer, excess raw material and subassembly inventories from the contract manufacturer deemed obsolete or slow-moving.

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We monitor the levels of the contract manufacturer s relevant inventories periodically and, if required, will write-off such deemed excess or obsolete inventory.

Impairment of long-lived assets. Our long-lived assets include property and equipment, long term investments, goodwill and other intangible assets. The fair value of the long-term investments is dependent upon the performance of the companies in which we have invested. In assessing potential impairment of these investments, we consider this factor as well as the forecast financial performance of the investees and other pertinent information. We record an investment impairment charge when we believe that the investment has experienced a decline in value that is other than temporary. As of June 30, 2003, the carrying value of our long-term investments was $1.2 million.

In assessing the recoverability of our property and equipment, goodwill and other intangible assets, we must make assumptions regarding the estimated future cash flows and other factors to determine the fair value of the respective assets. If these estimates or their related assumptions change in the future, we may be required to record impairment charges for these assets.

In July 2001, the Financial Accounting Standards Board issued SFAS No. 142 Goodwill and Other Intangible Assets . SFAS No. 142 addresses the initial recognition and measurement of intangible assets acquired in a business combination and the accounting for goodwill and other intangible assets subsequent to their acquisition. SFAS No. 142 provides that intangible assets with finite useful lives will be amortized and that goodwill and intangible assets with indefinite lives will not be amortized, but rather will be tested at least annually for impairment. We adopted SFAS No. 142 beginning January 1, 2002. Upon adoption of SFAS No. 142, we discontinued the amortization of recorded goodwill, which was approximately $3.4 million on an annual basis at that time. We performed an impairment test of our goodwill as of January 1, 2002 under the transitional provisions of SFAS No. 142; our test did not indicate an impairment of goodwill. We confirmed that we have only one reporting unit (the Company) to which we allocated all recorded goodwill, as well as all assets and liabilities.

By October 1, 2002, our stock price had declined significantly from January 1, 2002, at which point our market capitalization, based on our stock price, was below book value. The price of our ADSs on January 2, 2002 was $17.04 per ADS and declined to $8.47 per ADS on October 1, 2002. We determined the fair value of the Company based on relative market multiples for comparable businesses and a discounted cash flow model. This evaluation indicated that an impairment might exist. We then performed Step 2 under SFAS No. 142 in which the amount of the impairment loss, if any, must be measured. Four categories of intangible assets were identified as being separable from goodwill in accordance with SFAS No. 141. These included: trade names; an in-place distribution network; technology based intangible assets and maintenance contracts. In valuing the NICE trade name a relief from royalty method was used. Under this method, the value of a trade name reflects the savings realized by owning the trade name. The value of the intangible asset under the relief from royalty method is dependent upon the following factors: the selected royalty rate, the revenues expected to be generated from the underlying intellectual property, the discount rate and the expected life of the intellectual property. The value of our distribution network was determined through the use of the cost approach. Using this method, the value of the distribution network is estimated as the after-tax direct costs that a potential acquirer would avoid spending in recreating a similar functional distribution network. The value of the intangible asset under the cost method is dependent upon the estimated direct cost of establishing a new distributor relationship. Qualifying technology-based intangible assets consist of current and core technology and technologies that were under development at the valuation date. The current and core technology was valued using a derivation of the income approach, namely the excess earnings method. This method is used to analyze the earnings contribution of an intangible asset. Under this method, the excess earnings that an intangible asset generates are calculated over the intangible asset s expected life and discounted to the present to calculate the fair value of the intangible asset. Excess earnings are

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defined as the residual earnings after providing for appropriate returns on the other identified contributing assets. The value under the excess earnings method is dependent upon the following factors: the expected revenues generated by the intangible asset, the expected after-tax earnings on those revenues, the charges (or returns) required on other contributing assets and the discount rate. Our maintenance contracts, which are intangible assets under the contractual-legal criterion of SFAS No. 141, were valued using the excess earnings method. In determining the applicable discount rate to be used to estimate the fair value of our net assets, we calculated a market-derived rate based on the estimated weighted average cost of capital for the Company. In determining the cost of equity for the Company, we used a standard methodology based on the capital asset pricing model and analyzed selected guideline companies, industry data and factors specific to us. We expect to use a similar decision process in the future.

Following these analyses, we compared the carrying amount of goodwill to the implied fair value of the goodwill and determined that an impairment loss existed. A non-cash charge totaling $28.3 million was recorded in the fourth quarter of 2002 to write down goodwill to its fair value under the caption Goodwill impairment . This impairment is primarily attributable to the change in evaluation criteria for goodwill from an undiscounted cash flow approach, which was previously used under the guidance in Accounting Principles Board Opinion No. 17 *Intangible Assets*, to the fair value approach stipulated in SFAS No.142. The valuation of long-lived assets requires significant estimates and assumptions. These estimates contain management s best estimates, using appropriate and customary assumptions and projections at the time. If different estimates or projections were used, it is reasonably possible that our analysis would have generated materially different results.

Deferred income taxes. We record income taxes using the asset and liability approach. Deferred income tax assets and liabilities are recognized for future tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective income tax bases, and net operating loss and tax credit carryforwards. Our financial statements contain fully reserved tax assets which have arisen as a result of net operating losses, primarily incurred in 2001 and 2002, as well as other temporary differences between book and tax accounting. Significant management judgment is required in determining our provision for income taxes, our deferred tax assets and liabilities and any valuation allowance recorded against our net deferred tax assets. We have considered future taxable income, prudent and feasible tax planning strategies and other available evidence in determining the need for a valuation allowance. We evaluate all of these factors to determine whether it is more likely than not that some portion or all of the deferred income tax assets will not be realized. As a result of significant net operating losses incurred in 2001 and 2002 and uncertainty as to the extent and timing of profitability in future periods, we have continued to record a full valuation allowance, which was approximately $14.8 million as of June 30, 2003. The establishment and amount of the valuation allowance requires significant estimates and judgment and can materially affect our results of operations. If the realization of deferred tax assets in the future is considered more likely than not, an adjustment to the deferred tax assets would increase net income in the period such determination was made.

Our effective tax rate may vary from period to period based on changes in estimated taxable income or loss, changes to the valuation allowance, changes to state or foreign tax laws, future expansion into geographic areas with varying country, state and local income tax rates, deductibility of certain costs and expenses by jurisdiction and as a result of acquisitions, divestitures and reorganizations.

Contingencies. From time to time, we are defendant or plaintiff in various legal actions, which arise in the normal course of business. We are also a defendant in an intellectual property infringement action. We are required to assess the likelihood of any adverse judgments or outcomes to these matters as well as potential ranges of probable losses. A determination of the amount of reserves required for these contingencies, if any, which would be charged to earnings, is made after careful and considered analysis

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of each individual action together with our legal advisors. The required reserves may change in the future due to new developments in each matter or changes in circumstances, such as a change in settlement strategy. A change in the required reserves would affect our earnings in the period the change is made.

Restructuring. We established exit plans for each of the restructuring activities which took place in 2001 and 2002. In early 2001, with mounting evidence of an economic slowdown in the information technology and telecommunications sectors as well as changing business dynamics, we conducted a comprehensive review of our strategy, products, organization and infrastructure. This review culminated in the restructuring of our global operations, including the reduction of approximately 340 of our 1,110 employees, consolidation of our field facilities in North America, expansion of our local presence in Europe and Asia, and various other actions aimed at focusing on our core markets, products and competencies. We accounted for the 2001 plan in accordance with EITF Issue No. 94-3 Liability Recognition for Certain Employee Benefits and Other Costs to Exit an Activity (including Certain Costs incurred in a Restructuring) . Under EITF 94-3, an entity recognized a liability for an exit cost on the date that the entity committed itself to the exit plan. The exit cost included involuntary employee termination benefits, estimates regarding our ability to sub-lease vacated facilities, rates to be charged to a sub-tenant and the timing of the sub-lease arrangement and included an estimate of the timing of the pace and completion of the outsourcing of manufacturing to Flextronics, the contract manufacturer. During the fourth quarter of 2002, we reduced the restructuring accrual by $400 thousand to reflect mainly lower than estimated employee termination costs. Our remaining cash lease commitments net of sub-lease income related to restructured facilities are approximately $47 thousand, which is fully accrued in the accompanying balance sheet.

In July 2002, the Financial Accounting Standards Board issued SFAS No. 146 Accounting for Costs Associated with Exit or Disposal Activities , SFAS No. 146 requires that a liability for a cost that is associated with an exit activity be recognized only when the liability is incurred. It supersedes the guidance in EITF 94-3. In SFAS No. 146, an entity s commitment to a plan does not, by itself, create a present obligation to other parties that meets the definition of a liability and establishes that fair value is the objective for the initial measurement of the liability. Although SFAS No. 146 became effective for exit or disposal activities initiated after December 31, 2002, we elected to adopt the new ruling in respect of our fourth quarter 2002 restructuring plan. With the acquisition of TCS, we identified an opportunity to increase flexibility and focus, improve responsiveness and reduce unnecessary overhead. We adopted a plan to achieve these objectives in December 2002 which involves the phased reduction of approximately 140 of our initially combined 1,077 staff and consolidation of certain offices. Some of the involuntary reductions were effected in December and the liability related to those terminations of $282 thousand was utilized as of June 30, 2003. The remaining reductions in force and facility closures are planned to be implemented during 2003. We included in our results for the first six months of 2003 involuntary termination and facility closure costs of $1.3 million. Of this amount, at June 30, 2003, our remaining cash commitment was $537 thousand and related to lease obligations on restructured facilities.

In the event that we redefine our strategic direction and/or difficult economic conditions continue to prevail, we may be required to implement further restructuring measures. We are not currently able to determine whether or to what extent such circumstances may continue or worsen.

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Results of Operations

The following table sets forth selected consolidated income statement data for the three and six months ended June 30, 2003 and 2002 expressed as a percentage of total revenues. Figures may not add due to rounding:

	Three months ended June 30,		Six months ended June 30,	
	2002	**2003**	**2002**	**2003**
	Unaudited	**Unaudited**	**Unaudited**	**Unaudited**
Revenue				
Product	85.8%	78.0%	86.1%	76.7%
Services	14.2	22.0	13.9	23.3
Total revenue	100.0	100.0	100.0	100.0
Cost of revenue				
Product	43.5*	39.2*	44.5*	40.4*
Services	105.7*	83.7*	109.7*	79.1*
Total cost of revenue	52.3	49.0	53.6	49.4
Gross Profit	47.7	51.0	46.4	50.6
Operating Expenses:				
Research and development, net	11.0	10.3	11.4	10.6
Selling and marketing	24.3	23.3	24.6	24.2
General and administrative	14.6	13.5	14.5	13.6
Restructuring charges	0.0	1.5	0.0	1.2
Total operating expenses	49.9	48.5	50.5	49.5
Operating income (loss)	-2.2	2.5	-4.0	1.0
Financial income, net	3.6	0.6	3.1	0.8
Other income (expense), net	-0.9	0.0	-0.4	0.0
Income (loss) before taxes on income	0.5	3.1	-1.3	1.8
Taxes on income	0.4	0.6	0.2	0.3
Net income (loss)	0.1	2.5	-1.5	1.5

* Percent of related revenue.

Revenues. Our total revenues rose 47% to $56.2 million in the second quarter of 2003 from $38.2 million in the corresponding period in 2002. Total revenues for the first six months of 2003 increased 47% to $109.5 million from $74.3 million for the first six months of 2002. The increase is due primarily to the acquisition of TCS in November 2002 and market share gains.

Product revenues rose 34% to $43.9 million in the second quarter of 2003 from $32.8 million in the corresponding period in 2002. For the first six months of 2003, product revenues increased 31% to $84.0 million from $63.9 million in the corresponding prior year period. The increase is due primarily to a net $20.6 million (44%) increase in sales of our audio platform and related applications mainly to contact center, trading floor and public safety markets and a $4.6 million (51%) increase in digital video platform sales. These increases were partially offset by a $5.1 million (59%) decrease in sales of our COMINT/DF products. We believe that our growth in product sales to the contact center, financial trading floor and public safety markets principally reflects the acquisition of TCS and also market share gains. There can be no assurance that we will continue to experience market share gains or that, given the

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continuing weakened global economy, we will continue to report growth in audio platform and related software application sales. We believe that the high-end digital video market is still in its nascency and thus volatile; consequently, looking forward, we do not expect to experience the same degree of growth in revenues in future years as we did in the first six months of 2003.

Services revenues rose more than 100% to $12.4 million in the second quarter of 2003 from $5.4 million in the second quarter of 2002. Service revenues for the first six months of 2003 increased more than 100% to $25.5 million from $10.3 million in the corresponding period in 2002. The increase reflects an increasing portion of our installed base engaging us for maintenance services, higher installation and training revenues related to the increase in contact center and financial trading floor sales and the impact of the acquisition of TCS. Service revenues accounted for 23% of total revenues for the first six months of 2003 up from 14% in the first six months of 2002. Although we generate lower profit margins on services than on products, our strategy is to continue to grow our global services business, which we believe increases the competitiveness of our product offerings, and thus expect services to represent a growing portion of total revenues in the future.

Revenues in the second quarter of 2003 in the Americas, which includes the United States, Canada, Latin and South America, rose 38% to $29.3 million from $21.2 million in the second quarter of 2002. For the first six months of 2003, revenues in the Americas increased 50% to $59.1 million from $39.3 million for the corresponding prior year period. The increase is largely attributable to higher sales of products and services to contact center and financial trading floor markets and to the public safety market, following the acquisition of TCS. Second quarter 2003 sales to Europe, Middle East and Africa (EMEA) rose 75% to $17.7 million from $10.1 million in the second quarter of 2002. Sales in EMEA for the first six months of 2003 increased 52% to $35.0 million from $23.0 million for the first six months of 2002. The increase is due mainly to the acquisition of TCS in November 2002. Revenues in the second quarter of 2003 to Asia-Pacific (APAC) increased 33% to $9.1 million from $6.9 million in the second quarter of 2002. For the first six months of 2003, sales in APAC rose 29% to $15.4 million from $12.0 million for the corresponding period in 2002. The increase is due mainly to market share gains and the impact of the TCS acquisition.

Cost of Revenues. Cost of revenues was $27.6 million in the second quarter of 2003 compared with $20.0 million in the second quarter of 2002. Cost of revenues was $54.1 million in the first six months of 2003 compared with $39.8 million for the corresponding period in 2002.

Cost of product revenues rose 21% to $17.2 million in the second quarter of 2003 from $14.3 million in the second quarter of 2002. Cost of product revenues rose 19% to $33.9 million in the first six months of 2003 from $28.4 million in the corresponding period in 2002. The increase in cost in 2003 is due mainly to the higher sales volume. Cost of services revenue rose 80% to $10.3 million in the second quarter of 2003 from $5.7 million in the second quarter of 2002. Cost of services revenues rose 78% to $20.2 million in the first six months of 2003 from $11.3 million in the corresponding period in 2002. The increase in cost is due principally to higher labor, subcontractor and material costs associated with the growth in product installations and maintenance contracts.

Gross Profit. Gross profit on product revenues represented 60.8% of product revenues in the second quarter of 2003 compared with 56.5% in the second quarter of 2002. Gross profit on product revenues represented 59.6% of product revenues in the first six months of 2003 compared with 55.5% in the first six months of 2002 due mainly to a higher proportion of sales of our comparatively higher margin audio platform and applications in the sales mix, product manufacturing efficiencies achieved through completion of the outsourcing of manufacturing of our audio and video platforms to a contract manufacturer at the end of 2002 and engineering design modifications mainly to our digital video recording platform. Gross profit on services revenues represented 16.3% of services revenues in the second quarter of 2003 compared with a 5.7% loss on services revenues in the second quarter of 2002. Gross profit on services revenues represented 20.9% of services revenues in the first six months of 2003 compared with a 9.7% loss in the first six months of 2002. The improvement is due primarily to the higher growth rate in services revenues as compared with service expenses. For the reasons mentioned above, gross profit was $55.4 million or 50.6% of total revenues in the first six months of 2003 compared with $34.5 million or 46.4% of revenues in the corresponding period in 2002. On a forward-looking basis, we expect our gross margins to increase gradually as we realize the benefit of contract manufacturing efficiencies, of leveraging our global service operations and of a growing proportion of software applications in our product revenue mix.

Research and Development, Net. Research and development expense, before capitalization of software development costs and grants, increased to $6.9 million in the second quarter of 2003 from $5.5 million in the second quarter of 2002. For the first six months of 2003, research and development expense increased to $13.6 million from $11.2 million in the corresponding period in 2002 and represented 12.4% and 15.0% of revenues in 2003 and 2002, respectively. The increase in gross outlays was due mainly to the impact of the acquisition of TCS.

Software development costs capitalized in the second quarter of 2003 were $0.4 million compared with $0.9 million in the second quarter of 2002. For the first six months of 2003, capitalized software development costs were $1.0 million compared with $1.9 million for the corresponding period in 2002. Net research and development expense in the second quarter of 2003 increased 38% to $5.8 million from $4.2 million in the second quarter of 2002. Net research and development expense for the first six months of 2003 increased 37% to $11.6 million from $8.5 million in the corresponding period of 2002. Amortization of capitalized software development costs, included in cost of product revenues, was $1.0 million and $1.0 million in the second quarter of 2003 and 2002, respectively. Amortization of capitalized software development costs, included in cost of product revenues, was $2.0 million and $1.8 million for the first six months of 2003 and 2002, respectively.

Selling and Marketing Expenses. Selling and marketing expenses in the second quarter of 2003 increased 41% to $13.1 million from $9.3 million in the second quarter of 2002. For the first six months of 2003, selling and marketing expenses increased 45% to $26.5 million from $18.3 million for the corresponding period in 2002. The increase in selling and marketing expenses was due principally to higher labor-related costs mainly from the acquisition of TCS and higher commission expenses related to the higher sales. Selling and marketing expenses represented 24.2% of total revenues in the first six months of 2003 compared with 24.6% in the comparable period in 2002. We expect that we will continue to leverage our global sales and distribution infrastructure in the future such that selling and marketing expenses, while increasing on an absolute dollar basis, will decline modestly as a percentage of total revenues.

General and Administrative Expenses. General and administrative expenses increased 36% to $7.6 million in the second quarter of 2003 from $5.6 million in the second quarter of 2002. General and administrative expenses for the first six months of 2003 increased 38% to $14.9 million from $10.8 million in the corresponding period of 2002. General and administrative expenses represented 13.6% and 14.5% of total revenues for the first six months of 2003 and 2002, respectively. On a forward-looking basis, general and administrative expenses, while increasing on an absolute dollar basis, will decline as a percentage of total revenues.

Restructuring. In connection with the restructuring plan implemented in December 2002, we recorded restructuring and other related charges of $834 thousand in accordance with SFAS No. 146 in the second quarter of 2003 and $1.3 million for the first six months of the year.

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Financial Income, Net. Financial income, net decreased to $334 thousand in the second quarter of 2003 from $1.4 million in the second quarter of 2002. Financial income, net for the first six months of 2003 decreased to $893 thousand from $2.3 million in the corresponding period in 2002. The decrease reflects exchange losses related to the New Israel Shekel in 2003 compared with exchange gains related to the New Israel Shekel in 2002 and lower prevailing average market interest rates in 2003 compared with 2002.

Other Income (Expense), Net. Other income, net was $4 thousand in the second quarter of 2003 compared with other expense, net of $334 thousand in the second quarter of 2002. Other expense, net for the first six months of 2003 decreased to $33 thousand from $303 thousand in the corresponding period in 2002.

Taxes on Income. In the second quarter of 2003 we recorded a provision for income taxes of $314 thousand compared with $150 thousand in the second quarter of 2002. For the first six months of 2003 we recorded a provision for taxes of $364 thousand compared with $170 thousand in the corresponding period of 2002. The increase is primarily related to operating profits recorded at certain distribution subsidiaries where net operating loss carryforwards are not available to offset operating profits and changes in the Israeli tax laws.

Net Income. Net income for the second quarter of 2003 was $1.4 million compared with $52 thousand in the second quarter of 2002. Net income for the first six months of 2003 was $1.6 million compared with a net loss of $1.1 million in the first half of 2002. The improvement in 2003 resulted primarily from the increase in revenues and gross margin.

Liquidity and Capital Resources

We have historically financed our operations through cash generated from operations and sales of equity securities. We invest our excess cash in instruments that are highly liquid, investment grade securities. At June 30, 2003, we had approximately $87.0 million of cash and cash equivalents and short and long-term investments compared with $68.6 million at December 31, 2002 and $90.5 million at June 30, 2002. The increase in 2003 is due mainly to net operating cash flow.

For the first six months of 2003, cash provided by operations was $17.8 million compared with $6.2 million in the corresponding period in 2002. The improvement in 2003 compared with 2002 was primarily attributable to continued improvement in working capital and net income. We place particular focus on managing our working capital, particularly the level of accounts receivable days sales outstanding and inventories. Days sales outstanding (DSO) in accounts receivable at June 30, 2003 was 81 days compared with 100 days at June 30, 2002. The improvement is primarily attributable to the implementation of process improvements and our credit policy. We expect to see our DSO remain below 100 days during the second half of 2003.

Net cash used in investing activities was $12.7 million for the first six months of 2003 compared with $841 thousand in the first half of 2002. The increase reflects a higher portion of cash invested in marketable securities. Capital expenditures were $2.7 million in the first six months of 2003 and 2002. Capital expenditures in 2003 included investment in our global IT infrastructure systems and equipment for research and development and demonstration purposes. As of June 30, 2003 we have no material commitment for capital expenditures.

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Net cash provided by financing activities (mainly net proceeds from the issuance of shares upon the exercise of stock options) was $1.2 million and $1.4 million in the first six months of 2003 and 2002, respectively, primarily as a result of stock options exercised. We have available for use short-term revolving lines of credit at a number of commercial banks totaling up to $25 million. As of June 30, 2003, we also have available for use committed credit lines of $38 million secured by one of our commercial bond portfolios. There are no financial covenants associated with these credit lines. As of June 30, 2003, no amounts were drawn against our short-term lines of credit. The availability under the lines of credit has been reduced, however, by $5.8 million in outstanding guarantees and letters of credit. Additionally, we have one advance payment guarantee in the amount of $2.1 million which stipulates that we will have at least $20 million of cash and long term investments and shareholders equity of $100 million.

We believe that based on our current operating forecast, the combination of existing working capital, expected cash flows from operations and available credit lines will be sufficient to finance our ongoing operations for the next twelve months. Depending upon our future growth, the success of our business initiatives and acquisition opportunities, we will consider from time to time various financing alternatives and may seek to raise additional capital to finance our strategic efforts through debt or equity financing, the sale of non-strategic assets or to enter into strategic arrangements.

Qualitative and Quantitative Disclosure About Market Risk

Market risks relating to our operations result primarily from weak economic conditions in the markets in which we sell our products and changes in interest rates and exchange rates. To manage the volatility related to the latter exposure, we may enter into various derivative transactions. Our objective is to reduce, where it is deemed appropriate to do so, fluctuations in earnings and cash flows associated with changes in currency exchange rates. It is our policy and practice to use derivative financial instruments only to manage exposures. We do not use financial instruments for trading purposes and are not a party to any leveraged derivative.

Foreign Currency Risk. We conduct our business primarily in U.S. dollars but also in the currencies of the United Kingdom, Canada, the European Union and Israel. Thus, we are exposed to foreign exchange movements, primarily in UK, European and Israel currencies. We monitor foreign currency exposure and, from time to time, may enter into various contracts to preserve the value of sales transactions and commitments.

Interest Rate Risk. We invest in investment-grade U.S. corporate bonds and dollar deposits with FDIC-insured U.S. banks. Since these investments carry fixed interest rates and since our policy and practice is to hold these investments to maturity, interest income over the holding period is not sensitive to changes in interest rates. As of June 30, 2003 we had no other exposure to changes in interest rates and had no interest rate derivative financial instruments outstanding.

Recently Issued or Adopted Accounting Pronouncements

In April 2003, the FASB issued SFAS No. 149, Amendment of Statement 133 on Derivative Instruments and Hedging Activities . SFAS No. 149 amends and clarifies accounting for derivative instruments, including certain derivative instruments embedded in other contracts and for hedging activities under SFAS No. 133, Accounting for Derivatives and Hedging Activities . SFAS No. 149 is generally effective for derivative instruments, including derivative instruments embedded in certain contracts, entered into or modified after June 30, 2003. We do not expect the adoption of SFAS No. 149 to have a material impact on its operating results or financial condition.

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In May 2003, the FASB issued SFAS No. 150, Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity . SFAS No. 150 clarifies the accounting for certain financial instruments with characteristics of both liabilities and equity and requires that those instruments be classified as liabilities in statements of financial position. Previously, many of those financial instruments were classified as equity. SFAS No. 150 is effective for financial instruments entered into or modified after May 31, 2003 and otherwise is effective at the beginning of the first interim period beginning after June 15, 2003. As we do not have any of these financial instruments, the adoption of SFAS No. 150 is not expected to have any impact on our consolidated financial statements.

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CAPITALIZATION AND INDEBTEDNESS

The following table sets forth our cash and cash equivalents and capitalization as of June 30, 2003. This table should be read in conjunction with our interim consolidated financial statements for the six months ended June 30, 2003, which are incorporated herein by reference. The following information is unaudited.

	As of June 30, 2003
Cash and cash equivalents	$ 25,649
Short-term debt	
Long-term debt	
SHAREHOLDERS EQUITY:	
Share capital-	
Ordinary shares of NIS 1 par value:	
Authorized: 50,000,000 shares as of June 30, 2003;	
Issued and outstanding: 15,854,272 shares as of June 30, 2003	4,940
Additional paid-in capital	214,231
Deferred stock compensation	(6)
Accumulated other comprehensive income	2,013
Accumulated deficit	(62,507)
Total shareholders equity	158,671
Total capitalization	$ 158,671

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RISK FACTORS

You should carefully consider the risk factors described below before deciding whether to invest in the ADSs offered hereby. The most significant risks and uncertainties we face are described below, but they are not the only ones. Additional risks and uncertainties that are not presently known to us, that we currently deem immaterial or that are similar to those faced by other companies in our industry or business in general may also impair our business operations.

If any of the following risks actually occurs, our business, financial condition and results of operations could be materially and adversely affected. In this case, the trading price of our ordinary shares could decline, and you may lose all or part of your investment. Our actual results could differ materially from those anticipated in forward-looking statements contained in this prospectus as a result of various risks, including those discussed below and elsewhere in this prospectus. Please refer to Special Note Regarding Forward-Looking Statements on page 3.

Risks Relating to Our Business

The markets in which we operate are characterized by rapid technological changes and frequent new products and service introductions. We may not be able to keep up with these rapid technological and other changes.

We are operating in several markets, each characterized by rapidly changing technology and evolving industry standards. The introduction of products embodying new technology and the emergence of new industry standards can render existing products obsolete and unmarketable and can exert price pressures on existing products. We anticipate that a number of existing and potential competitors will be introducing new and enhanced products that could adversely affect the competitive position of our products. Our most significant market is the market for voice recording platforms and related enhanced applications (or Voice Platforms and Applications). Voice Platforms and Applications are utilized by entities operating in the contact center, trading floor, public safety and air traffic control segments to capture, store, retrieve and analyze recorded data. The market for our Voice Platforms and Applications is, in particular, characterized by a group of highly competitive vendors that are introducing rapidly changing competitive offerings around evolving industry standards.

Our ability to anticipate changes in technology and industry standards and to successfully develop and introduce new, enhanced and competitive products, on a timely basis, in all the markets where we operate, will be a critical factor in our ability to grow and be competitive. As a result, we expect to continue to make significant expenditures on research and development, particularly with respect to new software applications, which are continuously required in all our business areas. The convergence of voice and data networks and wired and wireless communications could require substantial modification and customization of our current products and business models, as well as the introduction of new products. Further, customer acceptance of these new technologies may be slower than we anticipate. We cannot assure you that the market or demand for our products will grow as rapidly as we expect, or if at all, that we will successfully develop new products or introduce new applications for existing products, that such new products and applications will achieve market acceptance or that the introduction of new products or technological developments by others will not render our products obsolete. In addition, our products must readily integrate with major third party security, telephone, front-office and back-office systems. Any changes to these third party systems could require us to redesign our products, and any such redesign might not be possible on a timely basis or achieve market acceptance. Our inability to develop products that are competitive in technology and price and responsive to customer needs could have a material adverse effect on our business, financial condition and results of operations.

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Continuing adverse conditions in the information technology sector may lead to a decreased demand for our Voice Platforms and Applications and may harm our business, financial condition and results of operations.

Our operating results may be materially adversely affected as a result of recent unfavorable economic conditions and reduced information technology spending, particularly in the product segments in which we compete. In particular, many enterprises, telecommunications carriers and service providers have reduced spending in connection with contact centers, and many financial institutions have reduced spending related to trading floors. These trends may adversely affect the growth of sales of new applications. If these industry-wide conditions persist, they will likely have an adverse impact, which may be material, on our business, financial condition and results of operations.

The integration of Thales Contact Solutions (or TCS), which we acquired in November 2002, has placed and will continue to place significant demands on our operations and financial resources. If we are unable to successfully integrate TCS into our business, our results of operations and financial condition may suffer.

We acquired TCS in November 2002. In general, the acquisition by one company of another company involves financial, operational and legal risks, including the difficulty of assimilating operations and personnel of the acquired company into the existing operations of the acquiror and of maintaining uniform standards, controls, procedures and policies across expanded operations. We cannot guarantee that we will be able to successfully integrate the management, people, product platforms, partners and distribution channels of TCS with our existing business or that we will be able to successfully manage our expanded operations. The integration of TCS with our business has required, and will continue to require, significant involvement by our senior officers, which places additional demands on our top management in addition to their day-to-day responsibilities in managing our business. In addition, due to the size and complexity of TCS s business and structure, the integration of TCS has placed and will continue to place significant demands on our operations and financial resources. If we fail to effectively integrate TCS into our business, such failure would likely have a material adverse effect on our business, financial condition and results of operations.

Our business could be materially adversely affected as a result of the risks associated with acquisitions and investments. In particular, we may not succeed in making additional acquisitions or be effective in integrating such acquisitions.

As part of our growth strategy, we have made a number of acquisitions and have made minority investments in complementary businesses, products or technologies. We frequently evaluate the tactical or strategic opportunity available related to complementary businesses, products or technologies. The process of integrating an acquired company s business into our operations and/or of investing in new technologies, may result in unforeseen operating difficulties and large expenditures and may absorb significant management attention that would otherwise be available for the ongoing development of our business. Other risks commonly encountered with acquisitions include the effect of the acquisition on our financial and strategic position and reputation, the failure of the acquired business to further our strategies, the inability to successfully integrate or commercialize acquired technologies or otherwise realize anticipated synergies or economies of scale on a timely basis and the potential impairment of acquired assets. Moreover, there can be no assurance that the anticipated benefits of any acquisition or investment will be realized. Future acquisitions or investments contemplated and/or consummated could result in potentially dilutive issuances of equity securities, the incurrence of debt and contingent liabilities, and amortization expenses related to intangible assets, any of which could have a material adverse effect on our operating results and financial condition. There can be no assurance that we will be successful in making additional acquisitions or effective in integrating such acquisitions into our existing business. In addition, if we consummate one or more significant acquisitions in which the consideration consists, in whole or in part, of ordinary shares or American Depositary Shares (ADSs), representing our ordinary shares, shareholders would suffer dilution of their interests in us.

We have also invested in companies which can still be considered in the start-up or development stages. These investments are inherently risky as the market for the technologies or products they have under development are typically in the early stages and may never materialize. We could lose our entire initial investment in these companies.

We have recently begun outsourcing the manufacture of our key products. The failure of our product manufacturers to meet our quality or delivery requirements would likely have a material adverse effect on our business, results of operations and financial condition.

During 2002, we entered into a manufacturing agreement with Flextronics Israel Ltd., a global electronics manufacturing services company. Under this agreement, Flextronics provides us with a comprehensive manufacturing solution that covers all aspects of the manufacture of our products from order receipt to product shipment, including purchasing, manufacturing, testing, configuration, and delivery services. This agreement currently covers all our products. In addition, in connection with the acquisition of Thales Contact Solutions (or TCS), we assumed a contract manufacturing agreement with Instem Technologies Ltd, a UK company, pursuant to which Instem manufactures all ex-TCS products. As a result of these arrangements, we are now fully dependent on Flextronics and Instem to process orders, manufacture our products and manage the shipping of our products. Consequently, the process of product orders, and the manufacturing and shipping of our products is not in our control.

We may from time to time experience delivery delays due to the inability of Flextronics and Instem to consistently meet our quality or delivery requirements and we may experience production interruptions if either of Flextronics or Instem is for any reason unable to continue the production of our products. Should we have on-going performance issues with our contract manufacturers, the process to move from one contractor to another is a lengthy and costly process that could affect our ability to execute customer shipment requirements and /or might negatively affect revenue and/or costs. If these manufacturers or any other manufacturer were to cancel contracts or commitments with us or fail to meet the quality or delivery requirements needed to satisfy customer orders for our products, we could lose time-sensitive customer orders and have significantly decreased quarterly revenues and earnings, which would have a material adverse effect on our business, results of operations and financial condition.

If we lose our key suppliers, our business may suffer.

Certain components and subassemblies that are used in the manufacture of our existing products are purchased from a single or a limited number of suppliers. In the event that any of these suppliers are unable to meet our requirements in a timely manner, we may experience an interruption in production until an alternative source of supply can be obtained. Any disruption, or any other interruption of a supplier s ability to provide components to us, could result in delays in making product shipments, which could have a material adverse effect on our business, financial condition and results of operations. In addition, some of our major suppliers use proprietary technology and software code that could require significant redesign of our products in the case of a change in vendor. Further, if suppliers discontinue their products, or modify them in manners incompatible with our current use, or use manufacturing processes and tools that could not be easily migrated to other vendors, we could have significant delays in product availability, which would have a significant adverse impact on our results of operations and financial condition. Although we generally maintain an inventory for some of our components and subassemblies to limit the potential for an interruption and we believe that we can obtain alternative sources of supply in the event our suppliers are unable to meet our requirements in a timely manner, we cannot assure you that our inventory and alternative sources of supply would be sufficient to avoid a material interruption or delay in production.

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Operating internationally exposes us to additional and unpredictable risks.

We sell our products throughout the world and intend to continue to increase our penetration of international markets. From 1998 to 2002, between approximately 96% and 99% of our total sales were derived from sales to customers outside of Israel, and between approximately 42% and 53% of our total sales were made to customers in North America. A number of risks are inherent in international transactions. Our future results could be materially adversely affected by a variety of factors including changes in exchange rates, general economic conditions, regulatory requirements, tax structures or changes in tax laws, and longer payment cycles in the countries in our geographic areas of operations. International sales and operations may be limited or disrupted by the imposition of governmental controls and regulations, export license requirements, political instability, trade restrictions, changes in tariffs and difficulties in managing international operations. We cannot assure you that one or more of these factors will not have a material adverse effect on our international operations and, consequently, on our business, financial condition and results of operations.

Our business strategy continues to evolve and, as a result, we may experience difficulty managing changes in our business.

Historically we have supplied the hardware and some software for implementing multimedia recording solutions. Our shift toward providing professional support services and an enterprise software business model has required and will continue to require substantial change, potentially resulting in some disruption to our business. These changes may include

- changes in management and technical personnel;
- expanded or differing competition resulting from entering the enterprise software market;
- increased need to expand our distribution network to include system integrators which could impact revenues and gross margins; and
- as our applications are sold either to our installed base or to new customers together with our recording platforms, the rate of adoption of our software applications by the market.

The changes in our business may place a significant strain on our operational and financial resources. We may experience substantial disruption from changes and could incur significant expenses and write-offs. We must carefully manage expense and inventory levels consistent with product demand and manage accounts receivable to limit credit risk. Inaccurate data (for example supply/demand forecasts) could quickly result in insufficient reserves.

We have recently expanded into new markets and may not be able to manage our expansion and anticipated growth effectively.

We have recently established a sales infrastructure in Hong Kong by relocating a portion of our Israel-based sales operations and by recruiting new managers and sales persons in order to bring about a growth in revenue in the Asia Pacific market. Also, in 2002 we expanded our presence in Europe (mainly in the United Kingdom) and in the Middle East and Africa (or the EMEA region) through organic growth and through our acquisition of TCS. The growth in our business in the EMEA region is still in its early stage, and in particular, we are just beginning to develop our digital video business in the EMEA

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region. We expect continued growth, particularly in connection with the enhancement and expansion of our operations in the EMEA region, as well as in the Asia Pacific region. We may establish additional operations within these regions where growth opportunities are projected to warrant the investment. However, we cannot assure you that our revenues will increase as a result of this expansion or that we will be able to recover the expenses we incurred in effecting the expansion. Our failure to effectively manage our expansion of our sales, marketing, service and support organizations could have a negative impact on our business. To accommodate our global expansion, we are continuously implementing new or expanded business systems, procedures and controls. There can be no assurance that the implementation of such systems, procedures, controls and other internal systems can be completed successfully.

If we lose our key personnel or cannot recruit additional personnel, our business may suffer.

If our growth continues, we will be required to hire and integrate new employees. Recruiting and retaining qualified engineers and computer programmers to perform research and development and to commercialize our products, as well as qualified personnel to market and sell those products, are critical to our success. As of December 31, 2002, approximately 25% of our employees were devoted to research and product development and 27% were devoted to marketing and sales. There can be no assurance that we will be able to successfully recruit and integrate new employees. Competition for highly skilled employees, including sales, technical and management personnel, may again become high in the technology industry. We may also experience personnel changes as a result of our move from multimedia recording equipment towards business performance solutions. An inability to attract and retain highly qualified employees may have an adverse effect on our ability to develop new products and enhancements for existing products and to successfully market such products, all of which would likely have a material adverse effect on our results of operations and financial position. Our success also depends, to a significant extent, upon the continued service of a number of key management, sales, marketing and technical employees, the loss of whom could materially adversely affect our business, financial condition and results of operations.

Inadequate intellectual property protections could prevent us from enforcing or defending our intellectual property and we may be subject to liability in the event our products infringe on the proprietary rights of third parties and we are not successful in defending such claims.

Our success is dependent, to a significant extent, upon our proprietary technology. We currently own ten patents (including seven in the United States) to protect our technology and we have 46 applications pending in the United States and other countries. We currently rely on a combination of patent, trade secret, copyright and trademark law, together with non-disclosure and non-competition agreements, to establish and protect the technology used in our systems. However, we cannot assure you that such measures will be adequate to protect our proprietary technology, that competitors will not develop products with features based upon, or otherwise similar to, our systems or that we will prevail in any proceeding instituted by us in order to enjoin competitors from selling similar products.

Although we believe that our products do not infringe upon the proprietary rights of third parties, we cannot assure you that one or more third parties will not make a contrary claim or that we will be successful in defending such claim. In June 2000, Dictaphone Corporation, one of our competitors, filed a patent infringement claim relating to certain technology embedded in some of our products. The claim is for damages for past infringement and enjoinment of any continued infringement of Dictaphone patents. In the court s discretion, the damages may be trebled and attorney fees awarded. As a result we might be forced to pay significant damages and licensing fees, modify our business practices or even be enjoined from conducting a significant part of our U.S. business. Any such results could materially harm our business. We believe, however, that we have a valid defense to this claim and are vigorously

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defending it. We have received notification from our insurance company indicating that the claim is not covered by our insurance policy; however, our insurance company has agreed to reimburse for us all legal expenses that we are expending in defense of the claim while reserving its final decision on this matter until the final outcome of the litigation. The discovery period is closed, dispositive motions have been filed with the Court, and we are awaiting the Court s decisions on these motions as well as scheduling for trial.

In April 2002, we received a letter from Dictaphone stating that several of our products were using technology protected by additional Dictaphone patents and offering us a licensing arrangement for these patents. We believe that none of our products infringe upon those patents.

From time to time, we receive cease and desist letters alleging patent infringements. No formal claims or other actions (aside from Dictaphone) have been filed with respect to such letters. We believe that none of these allegations has merit. We cannot assure you, however, that we will be successful in defending Dictaphone s infringement claim or other claims. We also cannot assure you that Dictaphone s claims, or others claims if asserted, will not have a material adverse effect on our business, financial condition, or operations. Defending the infringement claim or other claims could involve substantial costs and diversion of management resources. In addition, to the extent we are not successful in defending such claims, we may be subject to injunctions with respect to the use or sale of certain of our products or to liabilities for damages and may be required to obtain licenses which may not be available on reasonable terms.

We face potential product liability claims against us.

Our products focus specifically on organizations business-critical operations. We may be subject to claims that our products are defective or that some function or malfunction of our products caused or contributed to property, bodily or consequential damages. We minimize this risk by incorporating provisions into our distribution and standard sales agreements that are designed to limit our exposure to potential claims of liability. We carry product liability insurance in the amount of $15,000,000 per occurrence and $15,000,000 overall. No assurance can be given that all claims will be covered either by the contractual provisions limiting liability or by the insurance, or that the amount of any individual claim or all claims will be covered by the insurance or that the amount of any individual claim or all claims in the aggregate will not exceed policy coverage limits. A significant liability claim against us could have a material adverse effect on our results of operations and financial position.

Undetected problems in our products could directly impair our financial results.

If flaws in design, production, assembly or testing of our products (by us or our suppliers) were to occur, we could experience a rate of failure in our products that would result in substantial repair, replacement or service costs and potential liability and damage to our reputation. There can be no assurance that our efforts to monitor, develop, modify and implement appropriate test and manufacturing processes for our products will be sufficient to permit us to avoid a rate of failure in our products that results in substantial delays in shipment, significant repair or replacement costs or potential damage to our reputation, any of which could have a material adverse effect on our business, results of operations and financial condition.

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We face risks relating to government contracts.

We sell our products to, among other customers, governments and governmental entities. These sales are subject to special risks, such as delays in funding, termination of contracts or sub-contracts at the convenience of the government, termination, reduction or modification of contracts or sub-contracts in the event of changes in the government s policies or as a result of budgetary constraints, and increased or unexpected costs resulting in losses or reduced profits under fixed price contracts. Although to date we have not experienced any material problems in our performance of government contracts, or in the receipt of payments in full under such contracts, we cannot assure you that we will not experience problems in the future.

We depend on certain key strategic partners for sales of our products. If our relationship with these partners is for any reason impaired, our business and results of operations will likely suffer.

We have agreements in place with many distributors, dealers and resellers to market and sell our products and services in addition to our direct sales force. We derive a significant percentage of our revenues from one or more of our distributor channels. Our financial results could be materially adversely affected if our contracts with channel partners were terminated, if our relationship with channel partners were to deteriorate or if the financial condition of our channel partners were to weaken. In 2002, more than 57% of our indirect sales for Voice Platforms and Applications came from strategic partners, which accounted for a total of 39% of our entire Voice Platforms and Applications sales, or 32% of our entire sales. Our competitors ability to penetrate these strategic relationships, particularly our relationship with Avaya Inc. (formerly Enterprise Network Group of Lucent Technologies Inc.), our largest global distribution partner and one of the leading global providers of enterprise business communication platforms in voice, e-business and data, may result in a significant reduction of sales through that partner.

In addition, as our market opportunities change, we may have increased reliance on particular channel partners, which may negatively impact gross margins. There can be no assurance that we will be successful in maintaining or expanding these channels. If we are not successful, we may lose sales opportunities, customers and market share. In addition, there can be no assurance that our channel partners will not develop or market products or services in competition with us in the future.

We rely substantially on a single product.

We are dependent on the success of the NiceLog system and related products to maintain profitability. In 1998, 1999, 2000, 2001 and 2002, approximately and respectively, 94%, 88%, 84%, 79%, and 78% of our revenues were generated from sales of NiceLog systems and related products and we anticipate that such products will continue to account for a significant portion of our sales in the next several years. A significant decline in sales of NiceLog systems and related products, or a significant decrease in the profit margin on such products, could have a material adverse effect on our business, financial condition or results of operations.

Our service revenues are dependent on our installed base of customers.

We derive a significant portion of our revenues from services, which include maintenance, project management, support and training. As a result, if we lose a major customer or if a support contract is delayed or cancelled, our revenues would be adversely affected. In addition, customers who have accounted for significant services revenues in the past may not generate revenues in future periods. Our failure to obtain new customers or additional orders from existing customers could also materially affect our results of operations.

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The markets in which we operate are highly competitive and we may be unable to compete successfully.

The market for our products and related services, in general, is highly competitive. Additionally, some of our principal competitors such as Witness Inc. and Verint, Inc. may have significantly greater resources and larger customer bases than do we. We have seen evidence of deep price reductions by our competitors and expect to continue to see such behavior in the future, which, if we are required to match such discounting, will adversely affect our gross margins and results of operations. To date, we have been able to manage our product design and component costs. However, there can be no assurance that we will be able to continue to achieve reductions in component and product design costs. Further, the relative and varying rates of increases or decreases in product price and cost could have a material adverse impact on our earnings.

We are expanding the scope of our Voice Platforms and Applications to Enterprise Performance Management solutions, with a focus on analytic software solutions that are based on voice and data content analysis. The market for such content analysis applications is still in its early phases. Successful positioning of our products is a critical factor in our ability to maintain growth. Furthermore, new potential entrants from the traditional enterprise business intelligence and business analytics sector may decide to develop recording and content analysis capabilities and compete with us in this emerging opportunity. As a result, we expect to continue to make significant expenditures on marketing. We cannot assure you that the market awareness or demand for our new products will grow as rapidly as we expect, or if at all, that we will successfully develop new products or introduce new applications for existing products, that such new products and applications will achieve market acceptance or that the introduction of new products or technological developments by others will not adversely impact the demand for our products.

The recent expansion of Voice over Internet Protocol (or VOIP) into contact centers and trading floors may allow one or more of our competitors to take a leadership position with respect to this new technology. Strategic partners may change their vendor preference as a result. New developments of VOIP may lead to embedded VOIP recording as part of the VOIP switch or networking infrastructure. We cannot assure you that our products or existing partnerships will ensure sustainable leadership.

With respect to the market for digital video products and applications (or Video Platforms and Applications), our Video Platforms and Applications are utilized by entities in the CCTV security, gaming and retail industries to capture, store and analyze digital video and related data. The market for our Video Platforms and Applications is highly competitive and includes products offering a broad range of features and capacities. We compete with a number of large, established manufacturers of video recording systems and distributors of similar products, as well as new emerging competitors. The price per channel of digital recording systems has decreased throughout the market in recent years, primarily due to competitive pressures. We cannot assure you that the price per channel of digital recording systems will not continue to decrease or that our gross profit will not decrease as a result.

With respect to the public safety segment of our business, our ability to succeed depends on our ability to develop an effective network of distributors to the mid-low segment of the public safety market, while facing pricing pressures and low barriers to entry. We face significant competition from other well-established competitors, including Dictaphone Corporation, CVDS Inc., VoicePrint Inc. and others. Prices have decreased throughout the market in recent years, primarily due to competitive pressures. We cannot assure you that prices will not continue to decrease or that our gross profit will not decrease as a result. We believe that our ability to sell and distribute our Voice Platforms and Applications in the public safety market depends on the success of our marketing and product development initiatives. We cannot assure you that we will be successful in these initiatives.

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If the pace of spending by the U.S. Department of Homeland Security is slower than anticipated, our security business will likely be adversely affected, perhaps materially.

The market for our security solutions in CCTV continuous recording, public safety and law enforcement is highly dependent on the spending cycle and spending scope of the United States Department of Homeland Security, as well as local, state and municipal governments and security organizations in international markets. We cannot be sure that the spending cycle will materialize and that we will be positioned to benefit from the potential opportunities.

We may be unable to develop strategic alliances and marketing partnerships for the global distribution of our Video Platforms and Applications, which may limit our ability to successfully market and sell these products.

We believe that developing marketing partnerships and strategic alliances is an important factor in our success in marketing our Video Platforms and Applications and in penetrating new markets for such products. However, unlike our Video Platforms and Applications, we have just recently started to develop a number of strategic alliances for the marketing and distribution of our Video Platforms and Applications. We cannot assure you that we will be able to develop such partnerships or strategic alliances on terms that are favorable to us, if at all. Failure to develop such arrangements that are satisfactory to us may limit our ability to successfully market and sell our Video Platforms and Applications and may have a negative impact on our business and results of operations.

We may be unable to commercialize new video content analysis applications.

We are currently in the process of developing and commercializing new video content analysis applications that will enable real-time detection of security threats. The market for such video content analysis applications is still in an early phase. In addition, because this is a new opportunity for changing security procedures and represents a transition to proactive security management, we are not able to predict the pace at which security organizations will adopt this technology, if at all. Successful positioning of our products is a critical factor in our ability to maintain growth. New potential entrants to the market may decide to develop video content analysis capabilities and compete with us in this emerging opportunity. As a result, we expect to continue to make significant expenditures on marketing. We cannot assure you that a market for these products will develop as rapidly as we expect or at all, that we will successfully develop new products or introduce new applications for existing products, that new products or applications will meet market expectations and needs, that we will be successful in penetrating these markets and in marketing our products or that the introduction of new products or technological developments by others will not adversely impact the demand for our video content analysis applications.

We may be unable to sustain our position in certain specialized and early stage business markets.

The portion of our business that produces communication intelligence and direction finding applications for use by military intelligence operations is small in size and we are considered a niche player in this market. We are depending on systems integrators to assist us in growing this business. However, we cannot assure you that we will be able to sustain this business in the longer term.

In addition, our NiceTrack system for the lawful interception marketplace has been designed on a highly specific basis to meet the new European Telecommunications Standardization Institute standard. The implementation of this standard throughout Europe may be very slow and the potential of sales may be limited.

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We may have exposure to additional income tax liabilities.

As a global corporation, we are subject to income taxes both in Israel and various foreign jurisdictions. Our domestic and international tax liabilities are subject to the allocation of revenues and expenses in different jurisdictions and the timing of recognizing revenues and expenses. Additionally, the amount of income taxes paid is subject to our interpretation of applicable laws in the jurisdictions in which we file. From time to time, we are subject to income tax audits. While we believe we comply with all applicable income tax laws, there can be no assurance that a governing tax authority will not have a different interpretation of the law and assess us with additional taxes. Should we be assessed additional taxes, there could be a material adverse affect on our results of operations and financial condition.

We may be treated as a passive foreign investment company, which would have adverse tax consequences for our U.S. shareholders.

Based on our income, assets and activities for the year 2002, we believe that we were not a PFIC for that year, nor do we expect to become a PFIC in the foreseeable future. However, there can be no assurances that we will not be treated as a PFIC for that year or any taxable year. If we are or become a PFIC for any taxable year included in your holding period, we generally will remain a PFIC for all subsequent taxable years with respect to your holding of our ADSs, and there could be material adverse tax consequences to our U.S. shareholders. For a more detailed discussion, see U.S. Federal Income Tax Considerations Passive Foreign Investment Companies beginning on page 93 of our Annual Report on Form 20-F for the fiscal year ended December 31, 2002, filed with the Commission on June 26, 2003 and incorporated herein by reference.

Our business could be materially adversely affected by war, terrorism and natural disaster.

In the event of war, acts of terrorism or natural disaster, such as widespread disease, earthquake, or flood, we could experience significant business interruption. Such conflicts may also cause damage or disruption to transportation and communication systems, which could effect our suppliers ability to deliver products and to our employees and partners ability to conduct business and provide services.

Risks Relating to Israel

Our business may be impacted by inflation and NIS exchange rate fluctuations.

Exchange rate fluctuations between the United States dollar and the NIS may negatively affect our earnings. A substantial majority of our revenues and a substantial portion of our expenses are denominated in U.S. dollars. However, a significant portion of the expenses associated with our Israeli operations, including personnel and facilities related expenses, are incurred in NIS. Consequently, inflation in Israel will have the effect of increasing the dollar cost of our operations in Israel, unless it is offset on a timely basis by a devaluation of the NIS relative to the U.S. dollar. We cannot predict any future trends in the rate of inflation in Israel or the rate of devaluation of the NIS against the U.S. dollar. If the U.S. dollar cost of our operations in Israel increases, our dollar-measured results of operations will be adversely affected.

We are subject to the political, economic and military conditions in Israel.

Our headquarters, research and development and main manufacturing facilities are located in the State of Israel, and we are directly affected by the political, economic and military conditions to which Israel is subject. Since the establishment of the State of Israel in 1948, a number of armed conflicts have taken place between Israel and its Arab neighbors. A state of hostility, varying in degree and intensity, has

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led to security and economic problems for Israel. Since October 2000, there has been a high level of violence between Israel and the Palestinians, which has led to a crisis in the entire peace process and affected Israel s relationship with several Arab countries. Any armed conflicts or political instability in the region could negatively affect local business conditions and harm our results of operations. We cannot predict the effect on the region of the increase in the degree of violence between Israel and the Palestinians. Furthermore, several countries restrict doing business with Israel and Israeli companies, and additional companies may restrict doing business with Israel and Israeli companies as a result of the recent increase in hostilities. Our products are heavily dependent upon components imported from, and most of our sales are made to, countries outside of Israel. Accordingly, our operations could be materially adversely affected if trade between Israel and its present trading partners were interrupted or curtailed.

Some of our directors, officers and employees are currently obligated to perform annual military reserve duty. Additionally, in the event of a military conflict, including the ongoing conflict with the Palestinians, these persons could be required to serve in the military for extended periods of time. We cannot assess the full impact of these requirements on our workforce or business and we cannot predict the effect on us of any expansion or reduction of these obligations.

Service and enforcement of legal process on us and our directors and officers may be difficult to obtain.

Service of process upon our directors and officers, most of whom reside outside the United States, may be difficult to obtain within the United States. Furthermore, since the majority of our assets and most of our directors and officers are located outside the United States, any judgment obtained in the United States against us or these individuals or entities may not be collectible within the United States.

There is doubt as to the enforceability of civil liabilities under the Securities Act and the Securities Exchange Act in original actions instituted in Israel. However, subject to certain time limitations and other conditions, Israeli courts may enforce final judgments of United States courts for liquidated amounts in civil matters, including judgments based upon the civil liability provisions of those Acts.

We depend on the availability of government grants and tax benefits.

We derive and expect to continue to derive significant benefits from various programs and laws in Israel including tax benefits relating to our Approved Enterprise programs and certain grants from the Office of the Chief Scientist, or OCS, for research and development. To be eligible for these grants, programs and tax benefits, we must continue to meet certain conditions, including making certain specified investments in fixed assets and conducting the research, development and manufacturing of products developed with such OCS grants in Israel (unless a special approval has been granted). From time to time, the Israeli Government has discussed reducing or eliminating the availability of these grants, programs and benefits and there can be no assurance that the Israeli Government s support of grants, programs and benefits will continue. Pursuant to an amendment to Israeli regulations, income from two of our Approved Enterprises is exempt from income tax for only two years. Following this two-year period, the Approved Enterprise will be subject to corporate tax at a reduced rate of 10-25% (based on the percentage of foreign ownership in each taxable year) for the following eight years. Income from the other two Approved Enterprises is tax exempt for four years. Following this four-year period, the Approved Enterprises are subject to corporate tax at a reduced rate of 10-25% (based on the percentage of foreign ownership in each taxable year) for the following six years. If grants, programs and benefits available to us or the laws under which they were granted are eliminated or their scope is further reduced, or if we fail to meet the conditions of existing grants, programs or benefits and are required to refund grants or tax benefits already received (together with interest and certain inflation adjustments), our business, financial condition and results of operations could be materially adversely affected.

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Risks Related to Our Ordinary Shares and ADSs

Our share price is volatile and may decline.

Numerous factors, some of which are beyond our control, may cause the market price of our ordinary shares or our ADSs, each of which represents one ordinary share, to fluctuate significantly. These factors include, among other things, announcements of technological innovations, development of or disputes concerning our intellectual property rights, customer orders or new products by us or our competitors, currency exchange rate fluctuations, earning releases by us or our competitors, market conditions in the industry and the general state of the securities markets, with particular emphasis on the technology and Israeli sectors of the securities markets.

Our operating results in one or more future periods may fluctuate significantly and may cause our share price to be volatile.

The sales cycle for our products and services is variable, typically ranging between a few weeks to several months from initial contact with the potential client to the signing of a contract. Frequently, sales orders accumulate towards the latter part of a given quarter. Looking forward, given the lead time required by our contract manufacturer, if a large portion of sales orders are received late in the quarter, we may not be able to deliver products within the quarter and thus such sales will be deferred to a future quarter. There can be no assurance that such deferrals will result in sales in the near term, or at all. Thus, delays in executing client orders may affect our revenue and cause our operating results to vary widely. Additionally, as a high percentage of our expenses, particularly employee compensation, is relatively fixed, a variation in the level of sales, especially at or near the end of any quarter, may have a material adverse impact on our quarterly operating results.

In addition, our quarterly operating results may be subject to significant fluctuations due to other factors, including the timing and size of orders and shipments to customers, variations in distribution channels, mix of products, new product introductions, competitive pressures and general economic conditions. It is difficult to predict the exact mix of products for any period between hardware, software and services as well as within the product category between audio platforms and related applications, digital video and communications intelligence. Because a significant portion of our overhead consists of fixed costs, our quarterly results may be adversely impacted if sales fall below management s expectations. In addition, the period of time from order to delivery of our Audio and Video Platforms and Applications is short, and therefore our backlog for such products is currently, and is expected to continue to be, small and substantially unrelated to the level of sales in subsequent periods. As a result, our results of operations for any quarter may not necessarily be indicative of results for any future period. Due to all of the foregoing factors, in some future quarters our sales or operating results may be below our forecasts and the expectations of public market analysts or investors. In such event, the market price of our ordinary shares and ADSs would likely be materially adversely affected.

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Sales of our equity shares by the selling shareholder may adversely affect the prices of our equity shares and the ADSs.

Sales of substantial amounts of our equity shares in the public market, or the perception that such sales may occur, could adversely affect the prevailing market price of our equity shares or the ADSs or our ability to raise capital through an offering of our securities. In the future, we may also sponsor the sale of shares currently held by some of our shareholders, or issue new shares. We can make no prediction as to the timing of any such sales or the effect, if any, that future sales of our equity shares, or the availability of our equity shares for future sale, will have on the market price of our equity shares or ADSs prevailing from time to time.

An active or liquid trading market for our ADSs is not assured.

An active, liquid trading market for our ADSs may not be maintained in the long term. Loss of liquidity could increase price volatility.

ADS holders may be restricted in their ability to exercise voting rights.

At our request, The Bank of New York, as depositary for the American Depositary Receipts (the Depositary) will mail to you any notices of shareholder meetings received from us together with information explaining how to instruct the Depositary to exercise the voting rights of the securities represented by ADSs. If the Depositary receives voting instructions from you in time relating to matters that have been forwarded to you, it will endeavor to vote the securities represented by your ADSs in accordance with such voting instructions. However, the ability of the Depositary to carry out voting instructions may be limited by practical and legal limitations and the terms of the securities on deposit. We cannot assure that you will receive voting materials in time to enable you to return voting instructions to the Depositary in a timely manner. Securities for which no voting instructions have been received will not be voted. There may be other communications, notices or offerings that we only make to holders of our equity shares, which will not be forwarded to holders of ADSs. Accordingly, you may not be able to participate in all offerings, transactions or votes that are made available to holders of our equity shares.

USE OF PROCEEDS

All ADSs offered by this prospectus are being offered by the selling shareholder. We will not receive any proceeds from any sale of shares by the selling shareholder.

SELLING SHAREHOLDER

In November 2002, after all governmental consents or approvals required under the Sale and Purchase Agreement (as defined herein) were obtained, we acquired certain assets and liabilities of Thales Contact Solutions (or TCS), a developer of customer-facing technology for public safety, financial trading and customer contact centers, based in the United Kingdom, and the assets and business of TCS s subsidiaries, pursuant to the terms and conditions of that certain Sale and Purchase Agreement dated as of July 30, 2002, by and among the selling shareholder, NICE and certain of NICE s subsidiaries (the Sale and Purchase Agreement). In connection with the acquisition, we paid an initial $29.9 million in cash and issued 2,187,500 ordinary shares (the NICE Share Consideration) to the selling shareholder at a fair market value of $18.1 million calculated at the date of closing. As a result, the selling shareholder holds approximately 14% of our shares.

The Sale and Purchase Agreement provided for the cash portion of the purchase price to be subject to downward adjustment based on the value of net assets at closing and the full year 2002 sales of TCS. The Sale and Purchase Agreement also provided for contingent cash payments of up to $10 million in 2003, $7.5 million in 2004, and $7.5 million in 2005 if certain financial performance criteria are met as part of a three-year earn-out provision related to the sale of a particular product in 2002 through 2004.

Under the Sale and Purchase Agreement, the selling shareholder is entitled to nominate two directors to the board of directors of NICE, subject to approval of the NICE shareholders at a shareholders meeting and to appoint such directors between meetings. At the election of the selling shareholder, one of its nominees may serve on the audit committee of the board of directors. Upon closing, the selling shareholder nominated two directors, Mr. John Hughes, executive vice president and COO of Thales IT&S and Mr. Tim Robinson, senior vice president of the Secure Operations business group of the selling shareholder, and both were elected by NICE s shareholders at the shareholder meeting on December 24, 2002. If the selling shareholder sells or disposes of more than 50% of the NICE Share Consideration, one of its nominees to the board of directors will be required to immediately resign. If the selling shareholder sells or disposes of more than 75% of the NICE Share Consideration, or if the selling shareholder holds less than 2% of all issued and outstanding ordinary shares of NICE, the remaining nominee of the selling shareholder, if required by NICE or the board of directors, shall immediately resign from the board of directors.

On December 24, 2002, each of Mr. Hughes and Mr. Robinson was granted options to purchase 10,000 ordinary shares. The exercise price of the options is $10 (the higher of $10 or the closing price of our ADRs on the NASDAQ National Market on December 24, 2002). Twenty-five percent of the options will vest and become exercisable one year after the grant, with an additional 6.25% becoming exercisable at the end of each quarter thereafter. The options are exercisable during each of their terms as a director of NICE, with certain exceptions in the case of their death or disability. In any event, the options expire on December 24, 2008.

Under the Sale and Purchase Agreement, whenever (a) the selling shareholder has the right to designate one or more nominees to the board of directors or (b) the selling shareholder has serving on NICE s board of directors one or more nominees, the selling shareholder has agreed (i) to vote its ordinary shares of NICE in favor of NICE s board of director s recommendation as to additions, removals or substitutions to the board of directors and (ii) not to, individually or jointly with any others, initiate, propose, encourage, support or vote for the appointment or removal of any other person to the board of directors or any shareholder proposal relating to the appointment or removal of any nominee to the board of directors which is not supported by the board of directors of NICE.

Concurrently with the execution of the Sale and Purchase Agreement, Nice and the selling shareholder entered into that certain Standstill Agreement dated as of July 30, 2002 (the Standstill Agreement). In the Standstill Agreement, the selling shareholder agreed that, absent the prior written consent of NICE, neither it nor its controlled affiliates would directly or indirectly acquire, offer to acquire or agree to acquire NICE securities, if the acquisition would: (1) together with all securities of NICE (excluding the NICE Share Consideration) acquired by the selling shareholder or its controlled affiliates within the twelve months preceding such acquisition, consist of more than 2% of the number of ordinary shares issued and outstanding as of November 2, 2002; or (2) together with all securities of NICE (including any portion of the NICE Share Consideration) beneficially owned by the selling shareholder or its controlled affiliates, consist of more than 24% of the number of ordinary shares issued and outstanding as of November 2, 2002, after giving effect to the NICE Share Consideration. Further, under the Standstill Agreement, when the selling shareholder either has one or more of its nominees on the board of directors of NICE or has no nominees on the board of directors of NICE due to the nominees voluntary resignation or due to any acceptable reason , the selling shareholder agreed it will not (1) grant any proxies, (2) deposit any ordinary shares of NICE into a voting trust, (3) enter into a voting agreement with respect to any ordinary shares of NICE, or (4) make any solicitation of proxies to vote or seek to advise or influence any person with respect to the voting of any ordinary shares of NICE. The selling shareholder is, however, entitled to accept or participate in an unsolicited proposal or transaction of an independent third party on the same terms as other NICE shareholders. The Standstill Agreement terminates on November 2, 2004 (the second anniversary of the completion date). Furthermore, the Standstill Agreement will terminate if for any reason other than a bona fide dispute or an acceptable reason (each as defined in the Sale and Purchase Agreement), the selling shareholder s nominees to the board of directors of NICE are not appointed or re-appointed by NICE, or are removed or replaced by NICE.

On November 2, 2002, we entered into that certain Registration Rights Agreement by and between the selling shareholder and NICE relating to the NICE Share Consideration. Under the Registration Rights Agreement, we agreed to prepare and file under the Securities Act a registration statement covering the offer and sale of the ordinary shares. We agreed to bear the expense of such registration. Pursuant to the Registration Rights Agreement, we must use our reasonable commercial best efforts to keep the Registration Statement continuously effective until the later of (i) November 2, 2005 (the third anniversary of the completion date) or (ii) the date on which all of the shares are eligible to be sold or distributed pursuant to Rule 144 under the Securities Act.

The selling shareholder has advised us that, at the time of completion of NICE s acquisition of the assets of TCS, the selling shareholder was not a party to any contracts, arrangements, understandings or relationships (legal or otherwise) with respect to any securities of NICE, including transfer or voting of any of the securities, finder s fees, joint ventures, loan or option arrangements, puts or calls, guarantees of profits, division of profits or loss, or the giving or withholding of proxies.

All of the shares being offered hereby are being offered for the account of the selling shareholder. The selling shareholder is not an affiliate of a broker-dealer. The selling shareholder may sell the shares being offered hereby at any time or from time to time, in such amounts as the selling shareholder, in its sole discretion, determines, subject to the provisions of the Sale and Purchase Agreement described below under Plan of Distribution, and to the provisions of the Registration Rights Agreement described above. Neither the filing with the Securities and Exchange Commission of the registration statement of which this prospectus is a part nor the distribution of this prospectus should be construed to suggest that any or all of the shares being offered for the account of the selling shareholder are being offered for sale at any given time.

The following table sets forth certain information, as provided by the selling shareholder, with respect to the shares owned by the selling shareholder and the number of shares which may be offered for sale pursuant to this prospectus by the selling shareholder. This information was accurate as of the date such information was provided to us. The amount set forth may have increased or decreased since the date such information was provided.

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The shares may be offered from time to time by the selling shareholder named below. However, the selling shareholder is under no obligation to sell all or any portion of the shares, nor is the selling shareholder obligated to sell any shares immediately under this prospectus.

Since the selling shareholder may sell all or part of its ordinary shares and such offerings are not being underwritten on a firm commitment basis, no estimate can be given as to the number of ordinary shares that will be held by the selling shareholder upon termination of any offering made hereby.

	Shares Beneficially Owned Before An Offering		
Name of Selling Shareholder	Number of Shares	Percent of Total Outstanding Shares (as of June 30, 2003)	Number of Shares Being Registered Hereby
Thales SA 45 rue de Villiers Neuilly sur Seine France 92 200	2,016,100	14%	2,016,100

The selling shareholder has sole power to vote and dispose of the 2,016,100 ordinary shares issued to the selling shareholder. The directors, executive officers and controlling persons of the selling shareholder that have voting or dispositive power over the 2,016,100 ordinary shares issued to the selling shareholder are Denis Ranque, Jean-Paul Barth, Serge, Bertrand Dufourcq, Roger Norman Freeman, Louis Gallois, Benoit Tellier, Henri Proglio, Pierre Lafourcade, Daniel Lebegue, Serge, Marcel Roulet, Marie-Paule Delpierre, Didier Gladieu, Annie Legendre, Yves Barou, Bernard Retat, Alexandre de Juniac, Ross McInnes, John Hughes, Alex Dorrian, Jean-Paul Perrier, Jean-Loup Picard, Francois Lureau and Timothy Robinson. Thomson S.A., a holding company that is wholly-owned by the French State, beneficially owned 31.22% of the selling shareholder s outstanding shares as of December 31, 2002. No other shareholder of the selling shareholder owns a greater percentage than Thomson S.A. The French State, through Thomson S.A., may be deemed indirectly to control the selling shareholder. In addition to its holdings through Thomson S.A., a representative of the French State attends the selling shareholder s board meetings as a non-voting representative by virtue of the Golden Share arrangement instituted by French Decree No. 97-180, March 4, 1997. The Golden Share arrangement provides the French State with the right to (1) have representation on the selling shareholder s board of directors as set forth above, (2) approve the acquisition of more than 10 percent of the selling shareholder s capital shares and (3) approve the sale (or pledge) of a majority of the capital shares of any of the selling shareholder s principal subsidiaries that were owned as of March 4, 1997 and were listed in an Annex to Decree 97-180.

PLAN OF DISTRIBUTION

We are registering ADSs representing ordinary shares on behalf of the selling shareholder. As used in this prospectus, selling shareholder includes donees and pledgees selling ADSs representing ordinary shares received from the selling shareholder after the date of this prospectus. The selling shareholder may from time to time sell all or any portion of their ADSs representing ordinary shares in one or more types of transactions on The Nasdaq National Market, which may include block transactions, in the over-the-counter market, in privately negotiated transactions, through options or other derivative transactions relating to the ADSs to cover short sales, or a combination of such methods of sale, in such a manner at such price and on such terms as they may determine, subject to the provisions of the Sale and Purchase Agreement described below and to the provisions of the Registration Rights Agreement described above.

Under the Sale and Purchase Agreement, the selling shareholder agreed that it will not sell, assign, transfer, pledge, encumber or otherwise dispose of: (i) any of its ADSs representing ordinary shares prior to November 2, 2003 (the first anniversary of the completion date); (ii) more than 25% of its ADSs representing ordinary shares prior to November 2, 2004 (the second anniversary of the completion date); and (iii) more than 50% of its ADSs representing ordinary shares prior to May 31, 2005 (the end of 30 months after the completion date). The selling shareholder has further agreed that neither it nor any of its affiliates will engage in (i) any hedging or monetization strategies with respect to its ADSs representing ordinary shares at any time prior to November 2, 2003 and (ii) any short sales at any time during which the selling shareholder has a nominee on the board of directors of NICE. At any time after November 2, 2003, in the event of a bona fide dispute that results in the resignation of all selling shareholder nominees to the board of directors of NICE (but excluding a resignation of such nominees for any other reason), the time periods described above will be reduced to the lesser of 6 months or the remaining time period for its ADSs representing ordinary shares still subject to such restrictions as of the date of resignation of the selling shareholder s nominees to the board of directors. Upon expiration of the time periods described above, the selling shareholder may sell, assign, transfer or otherwise dispose of its ADSs representing ordinary shares subject to orderly marketing arrangements described herein.

Under the Sale and Purchase Agreement, when the selling shareholder either (a) has one or more nominees on the board of directors of NICE or (b) has no nominees on the board of directors due to its nominees voluntary resignation or due to any acceptable reason , the selling shareholder has agreed it will (i) make all sales of its ADSs representing ordinary shares through Nasdaq; (ii) make no sales of its ADSs representing ordinary shares at a discount of more than 10% to the last reported sale price immediately prior to the trade or the previous day s closing sale price on Nasdaq, and (iii) give NICE two Nasdaq trading days notice prior to a sale comprising 1% or more of the issued and outstanding shares of NICE. Further, no sales by the selling shareholder of its ADSs representing ordinary shares may be made unless a registration statement under the Securities Act is in effect. In addition, if the selling shareholder has a board of directors nominee or beneficially owns 5% of the outstanding ordinary shares of NICE, sales by the selling shareholder are subject to NICE s internal policies regarding sales by officers, directors and affiliates of NICE.

Additionally, the selling shareholder has agreed that when it has no nominees on the board of directors of NICE (for any reason other than an acceptable reason) it will make no sale not effected on Nasdaq, unless the selling shareholder gives NICE (or NICE s designee) (i) not less than five business days notice of such proposed sale and (ii) a right of first refusal to acquire the relevant shares on the same terms as offered in such off-Nasdaq sale. NICE s right of first refusal will expire if NICE (or its designee) fails to purchase the shares within the five business day period. NICE does not have a right of first refusal: (A) when such off-Nasdaq transaction is to a financial institution acting as intermediary, which no later than the date of its purchase of ordinary shares of NICE has committed to dispose of such ordinary shares in transactions effected on Nasdaq to multiple financial institutions or (B) the transaction involves a sale to a single financial institution purchasing ordinary shares of NICE for its own account. Where either (A) or (B) is applicable, the selling shareholder must give NICE two business days prior notice before the relevant transaction is effected.

At any time, the selling shareholder may effect the following transfers of its ADSs representing ordinary shares: (a) any transfer to any of its affiliates; (b) any bona fide pledge to a financial institution as security for any indebtedness; or (c) any transfer in connection with the sale of all or substantially all of the assets of the selling shareholder.

The selling shareholder also may resell all or a portion of its ADSs representing ordinary shares in open market transactions in reliance upon Rule 144 under the Securities Act, provided it meets the criteria and conforms to the requirements of such rule. Any of the transactions described above may or may not involve brokers or dealers. The selling shareholder has advised us that it has not entered into any agreements, understandings or arrangements with any underwriters or broker-dealers regarding the sale of its securities, nor is there an underwriter or coordinating broker acting in connection with the proposed sale of ADSs representing ordinary shares by the selling shareholder.

The selling shareholder may effect sale transactions by selling ADSs representing ordinary shares directly to purchasers or to or through broker-dealers, which may act as agents or principals. Such broker-dealers may receive compensation in the form of discounts, concessions, or commissions from the selling shareholder and/or the purchasers of ADSs representing ordinary shares for whom such broker-dealers may act as agents or to whom they sell as principals, or both. Compensation as to a particular broker-dealer might be in excess of customary commissions.

The selling shareholder and any broker-dealers that act in connection with the sale of ADSs representing ordinary shares might be deemed to be underwriters within the meaning of Section 2(11)

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of the Securities Act, and any commissions received by such broker-dealers and any profit on the resale of the ADSs sold by them while acting as principals might be deemed to be underwriting discounts or commissions under the Securities Act. We have agreed to indemnify the selling shareholder against certain liabilities, including liabilities arising under the Securities Act. The selling shareholder may agree to indemnify any agent, dealer or broker-dealer that participates in transactions involving sales of ADSs against certain liabilities, including liabilities arising under the Securities Act.

Because the selling shareholder may be deemed to be an underwriter within the meaning of Section 2(11) of the Securities Act, the selling shareholder will be subject to the prospectus delivery requirements of the Securities Act. We have informed the selling shareholder that the anti-manipulative provisions of Regulation M promulgated under the Securities Exchange Act may apply to its sales in the market. Regulation M generally provides that, during an offering by a selling shareholder, such shareholder may not bid for, purchase, or attempt to induce any person to bid for or purchase, the securities being offered.

Pursuant to Rule 416 of the Securities Act, the selling shareholder may also offer ordinary shares issued as a result of stock splits, stock dividends and anti-dilution provisions.

Upon a selling shareholder notifying us that he, she or it has entered into any material arrangement with a broker-dealer for the sale of ordinary shares or ADSs through a block trade, special offering, exchange distribution or secondary distribution or a purchase by a broker or dealer, we will file a supplement to this prospectus, if required, pursuant to Rule 424(b) under the Securities Act, disclosing:

- The name of each such selling shareholder and of the participating broker-dealer(s);
- The number of ordinary shares or ADSs involved;
- The price at which such ordinary shares or ADSs were sold;
- The commissions paid or discounts or concessions allowed to such broker-dealer(s), where applicable;
- That such broker-dealer(s) did not conduct any investigation to verify the information set out or incorporated by reference in this prospectus; and
- Other facts material to the transaction.

To the extent required, this prospectus may be amended or supplemented from time to time to describe a specific plan of distribution.

We have agreed with the selling stockholders to keep the Registration Statement, which includes this prospectus, effective until the later of (i) November 2, 2005 or (ii) the date on which all securities to which this prospectus relates are eligible to be sold or distributed pursuant to Rule 144 (or any successor provision) under the Securities Act within any consecutive three-month period, without volume limitations.

The following table sets forth the fees and expenses payable by NICE in connection with the registration and offering of the securities under the Registration Statement:

Securities and Exchange Commission Filing Fee	$ 3,519.91
Accounting Fees and Expenses	*15,000.00
Legal Fees and Expenses	*30,000.00
Miscellaneous Fees and Expenses (i.e. printing, ADS issuance)	* 2,000.00
Total	$ *50,519.91

* Estimated

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NICE has agreed to pay all of the expenses incident to the issuance and registration of the ADSs. NICE has not agreed to pay out-of-pocket expenses and legal fees incurred by the selling shareholder.

LEGAL MATTERS

The validity of the ordinary shares underlying the ADSs will be passed upon for NICE by Gross, Kleinhendler, Hodak, Halevy, Greenberg & Co., Tel-Aviv, Israel, Israeli counsel to NICE. Brown Raysman Millstein Felder & Steiner LLP, New York, New York, has acted as U.S. counsel to NICE in connection with the filing of the Registration Statement to which this prospectus relates.

EXPERTS

The consolidated financial statements of NICE included in our annual report on Form 20-F for the year ended December 31, 2002, which are incorporated by reference in this prospectus and the Registration Statement of which this prospectus forms a part, have been audited by Kost, Forer & Gabbay, a member of Ernst & Young Global, independent public accountants, as indicated in their report with respect thereto. Such financial statements are incorporated by reference in reliance upon the report of such firm given upon their authority as experts in auditing and accounting.

The balance sheet of Thales Contact Solutions and certain other subsidiaries of Thales S.A. relating to the business and assets acquired by NICE in connection with its acquisition of Thales Contact Solutions as at December 31, 2001 and December 31, 2000, and the related statements of operations and cash flows for the year ended December 31, 2001 and the six months ended December 31, 2000, which have been included in this prospectus and the Registration Statement of which this prospectus forms a part, have been audited by Barbier, Frinault & Autres, Reseau Ernst &Young, independent public accountants, as indicated in their report with respect thereto, and are included herein in reliance upon the report of such firm given upon their authority as experts in auditing and accounting.

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NICE SYSTEMS LTD. AND SUBSIDIARIES

INTERIM CONSOLIDATED FINANCIAL STATEMENTS

AS OF JUNE 30, 2003

U.S. DOLLARS IN THOUSANDS

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INTERIM CONSOLIDATED BALANCE SHEETS

U.S. dollars in thousands

	June 30, 2003	December 31, 2002
	Unaudited	
ASSETS		
CURRENT ASSETS:		
Cash and cash equivalents	$ 25,649	$ 19,281
Short-term bank deposits	179	208
Marketable securities	28,813	33,853
Trade receivables (net of allowance for doubtful accounts of $ 6,034 and $ 6,010 at June 30, 2003 and December 31, 2002, respectively)	41,544	45,863
Unbilled receivables	3,191	7,495
Other receivables and prepaid expenses	9,131	8,234
Related party receivables	6,169	12,804
Inventories	15,083	13,480
Total current assets	129,759	141,218
LONG-TERM INVESTMENTS:		
Long-term marketable securities	32,355	15,247
Investment in affiliate	1,200	1,200
Severance pay fund	6,532	5,490
Long-term receivables and prepaid expenses	886	888
Total long-term investments	40,973	22,825
PROPERTY AND EQUIPMENT, NET	20,972	24,345
INTANGIBLE ASSETS, NET	18,523	20,483
GOODWILL	22,417	27,417
Total assets	$ 232,644	$ 236,288

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

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INTERIM CONSOLIDATED BALANCE SHEETS

U.S. dollars in thousands (except share data)

	June 30, 2003	December 31, 2002
	Unaudited	
LIABILITIES AND SHAREHOLDERS EQUITY		
CURRENT LIABILITIES:		
Short-term bank credit	$	$ 24
Trade payables	15,797	16,129
Accrued expenses and other liabilities	47,336	45,859
Total current liabilities	63,133	62,012
LONG-TERM LIABILITIES:		
Accrued severance pay	7,451	6,240
Other long-term liabilities	3,389	13,500
Total long-term liabilities	10,840	19,740
COMMITMENTS AND CONTINGENT LIABILITIES		
SHAREHOLDERS EQUITY:		
Share capital-		
Ordinary shares of NIS 1 par value:		
Authorized: 50,000,000 shares as of June 30, 2003 and December 31, 2002;		
Issued and outstanding: 15,854,272 and 15,704,425 shares as of June 30, 2003 and December 31, 2002, respectively	4,941	4,908
Additional paid-in capital	214,231	213,003
Deferred stock compensation	(6)	(12)
Accumulated other comprehensive income	2,012	782
Accumulated deficit	(62,507)	(64,145)
Total shareholders equity	158,671	154,536
Total liabilities and shareholders equity	$ 232,644	$ 236,288

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

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INTERIM CONSOLIDATED STATEMENTS OF OPERATIONS

U.S. dollars in thousands (except per share data)

	Six months ended June 30, 2003	Six months ended June 30, 2002	Year ended December 31, 2002
	Unaudited		
Revenues:			
Products	$ 84,022	$ 63,943	$ 134,783
Services	25,500	10,341	27,722
Total revenues	109,522	74,284	162,505
Cost of revenues:			
Products	33,936	28,445	58,693
Services	20,178	11,348	26,054
Total cost of revenues	54,114	39,793	84,747
Gross profit	55,408	34,491	77,758
Operating expenses:			
Research and development, net	11,608	8,468	17,925
Selling and marketing	26,524	18,271	40,494
General and administrative	14,856	10,752	23,806
Amortization of acquired intangible assets, restructuring expenses, in-process research and development and goodwill impairment	1,278		29,092
Total operating expenses	54,266	37,491	111,317
Operating income (loss)	1,142	(3,000)	(33,559)
Financial income, net	893	2,335	3,992
Other expenses, net	(33)	(303)	(4,065)
Income (loss) before taxes on income	2,002	(968)	(33,632)
Taxes on income	364	170	350
Net income (loss)	$ 1,638	$ (1,138)	$ (33,982)
Basic income (loss) per share	$ 0.10	$ (0.09)	$ (2.46)
Diluted income (loss) per share	$ 0.10	$ (0.09)	$ (2.46)

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

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INTERIM CONSOLIDATED STATEMENTS OF CASH FLOWS

U.S. dollars in thousands

	Six months ended June 30,		Year ended December 31,		
	2003	**2002**	**2002**		
	Unaudited				
Cash flows from operating activities:					
Net income (loss)	$ 1,638	$ (1,138)	$ (33,982)		
Adjustments required to reconcile net income (loss) to net cash provided by operating activities:					
Depreciation and amortization	9,203	1.3 %	‡489,656 shares common stock (acquired 5-1-00)	3,550,006	11,188,640

†Publicly-owned company ¥ Control investment * Affiliated investment ‡Unrestricted securities as defined in Note (b)

The accompanying Notes are an integral part of these Consolidated Financial Statements

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CAPITAL SOUTHWEST CORPORATION AND SUBSIDIARIES

CONSOLIDATED SCHEDULE OF INVESTMENTS
(Unaudited)
September 30, 2011

Company	Equity (a)		Investment (b)	Cost	Value (c)
TRAX HOLDINGS, INC. Scottsdale, Arizona Provides a comprehensive set of solutions to improve the transportation validation, accounting, payment and information management process.	29.6	%	18% convertible promissory note, $3,200,000 principal due 2012 (acquired 4-6-11 thru 5-6-11)	2,650,000	2,650,000
			1,061,279 shares Series A Convertible Preferred Stock, convertible into 1,061,279 common stock at $4.64 per share (acquired 12-8-08 and 2-17-09)	5,000,000	5,800,000
				7,650,000	8,450,000
VIA HOLDINGS, INC. Sparks, Nevada Designer, manufacturer and distributor of high-quality office seating.	3.2	%	12,686 shares common stock (acquired 3-4-11 and 3-25-11)	4,926,290	2
*WELLOGIX, INC. Houston, Texas Developer and supporter of software used by the oil and gas industry.	19.2	%	4,788,371 shares Series A-1 Convertible Participating Preferred Stock, convertible into 4,788,371 shares of common stock at $1.0441 per share (acquired 8-19-05 thru 6-15-08)	5,000,000	2
¥THE WHITMORE MANUFACTURING COMPANY Rockwall, Texas Specialized surface mining, railroad and industrial lubricants; coatings for automobiles and primary metals; fluid contamination control devices.	80.0	%	80 shares common stock (acquired 8-31-79)	1,600,000	59,600,000
MISCELLANEOUS	–		Ballast Point Ventures II, L.P. 2.2% limited partnership interest (acquired 8-4-08 thru 6-18-10)	1,425,000	1,425,000
	–		BankCap Partners Fund I, L.P.	5,762,270	5,150,520

		5.5% limited partnership interest (acquired 7-14-06 thru 5-2-11)		
–		CapitalSouth Partners Fund III, L.P. 1.9% limited partnership interest (acquired 1-22-08 and 2-12-09)	831,256	862,000
100.0	%	¥CapStar Holdings Corporation 500 shares common stock (acquired 6-10-10)	3,703,619	4,365,593
–		Diamond State Ventures, L.P. 1.4% limited partnership interest (acquired 10-12-99 thru 8-26-05)	76,000	174,965

†Publicly-owned company ¥ Control investment * Affiliated investment ‡Unrestricted securities as defined in Note (b)

The accompanying Notes are an integral part of these Consolidated Financial Statements

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CAPITAL SOUTHWEST CORPORATION AND SUBSIDIARIES

CONSOLIDATED SCHEDULE OF INVESTMENTS
(Unaudited)
September 30, 2011

Company	Equity (a)	Investment (b)	Cost	Value (c)
MISCELLANEOUS (continued)	–	¥Discovery Alliance, LLC 90.0% limited liability company (acquired 9-12-08 thru 6-20-11)	1,080,000	713,904
	–	Essex Capital Corporation 10% unsecured promissory note due 8-19-10 (acquired 8-16-09)	–	500,000
	–	First Capital Group of Texas III, L.P. 3.0% limited partnership interest (acquired 12-26-00 thru 8-12-05)	778,895	611,875
	100 %	¥Humac Company 1,041,000 shares common stock (acquired 1-31-75 and 12-31-75)	–	147,000
	–	STARTech Seed Fund I 12.1% limited partnership interest (acquired 4-17-98 thru 1-5-00)	178,066	40,773
	–	STARTech Seed Fund II 3.2% limited partnership interest (acquired 4-28-00 thru 2-23-05)	843,891	317,671
	–	Sterling Group Partners I, L.P. 1.6% limited partnership interest (acquired 4-20-01 thru 1-24-05)	1,064,042	629,500
TOTAL INVESTMENTS			$ 101,643,379	$ 443,927,522

†Publicly-owned company ¥ Control investment * Affiliated investment ‡Unrestricted securities as defined in Note (b)

The accompanying Notes are an integral part of these Consolidated Financial Statements

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CAPITAL SOUTHWEST CORPORATION AND SUBSIDIARIES

CONSOLIDATED SCHEDULE OF INVESTMENTS

March 31, 2011

Company	Equity (a)		Investment (b)	Cost	Value (c)
¥†ALAMO GROUP INC. Seguin, Texas Tractor-mounted mowing and mobile excavation equipment for governmental, industrial and agricultural markets; street-sweeping equipment for municipalities.	22.0	%	2,830,300 shares common stock (acquired 4-1-73 thru 5-25-07)	$ 2,190,937	$ 62,266,600
ALL COMPONENTS, INC. Pflugerville, Texas Electronics contract manufacturing; distribution and production of memory and other components for computer manufacturers, retailers and value-added resellers.	80.4	%	8.25% subordinate note, $2,000,000 principal due 2012 (acquired 6-27-07)	2,000,000	2,000,000
			150,000 shares Series A Convertible Preferred Stock; convertible into 600,000 shares of common stock at $0.25 per share (acquired 9-16-94)	150,000	8,431,388
			Warrant to purchase 350,000 shares of common stock at $11.00 per share, expiring 2017 (acquired 6-27-07)	–	3,068,552
				2,150,000	13,499,940
ATLANTIC CAPITAL BANCSHARES, INC Atlanta, Georgia Holding company of Atlantic Capital Bank, a full service commercial bank.	1.9	%	300,000 shares common stock (acquired 4-10-07)	3,000,000	2,257,000
¥BALCO, INC. Wichita, Kansas Specialty architectural products used in the construction and remodeling of commercial and institutional buildings.	90.9	%	445,000 shares common stock and 60,920 shares Class B non-voting common stock (acquired 10-25-83 and 5-30-02)	624,920	5,200,000
*BOXX TECHNOLOGIES, INC. Austin, Texas	14.9	%	3,125,354 shares Series B Convertible Preferred Stock,	1,500,000	2

Workstations for computer graphic imaging and design.			convertible into 3,125,354 shares of common stock at $0.50 per share (acquired 8-20-99 thru 8-8-01)		
CINATRA CLEAN TECHNOLOGIES, INC. Houston, Texas Cleans above ground oil storage tanks with a patented, automated system.	68.8	%	12% subordinated secured promissory note, due 2012 (acquired 5-19-10 thru 10-20-10)	890,604	890,604
			10% subordinated secured promissory note, due 2013 (acquired 7-14-08 thru 4-28-10)	6,200,700	6,200,700
			3,033,410 shares Series A Convertible Preferred Stock, convertible into 3,033,410 shares common stock at $1.00 per share (acquired 7-14-08 thru 11-18-10)	3,033,410	3,033,410
				10,124,714	10,124,714

†Publicly-owned company ¥ Control investment * Affiliated investment ‡Unrestricted securities as defined in Note (b)

The accompanying Notes are an integral part of these Consolidated Financial Statements

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CAPITAL SOUTHWEST CORPORATION AND SUBSIDIARIES

CONSOLIDATED SCHEDULE OF INVESTMENTS

March 31, 2011

Company	Equity (a)		Investment (b)	Cost	Value (c)
*†ENCORE WIRE CORPORATION McKinney, Texas Electric wire and cable for residential, commercial and industrial construction use.	16.9	%	4,086,750 shares common stock (acquired 7-16-92 thru 10-7-98)	5,800,000	81,735,000
EXTREME INTERNATIONAL, INC. Sugar Land, Texas Owns Bill Young Productions, Texas Video and Post, and Extreme and television commercials and corporate communications videos.	53.6	%	13,035 shares Series A Common Stock (acquired 9-26-08 and 12-18-08)	325,875	815,000
			39,359.18 shares Series C Convertible Preferred Stock, convertible into 157,437.72 shares of common stock at $25.00 per share (acquired 9-30-03)	2,625,000	9,850,000
			3,750 shares 8% Series A Convertible Preferred Stock, convertible into 15,000 shares of common stock at $25.00 per share (acquired 9-30-03)	375,000	938,000
				3,325,875	11,603,000
¥†HEELYS, INC. Carrollton, Texas Heelys stealth skate shoes, equipment and apparel sold through sporting goods chains, department stores and footwear retailers.	31.6	%	9,317,310 shares common stock (acquired 5-26-00)	102,490	19,193,659
†HOLOGIC, INC. Bedford, Massachusetts Medical instruments including bone densitometers, mammography devices and digital radiography systems.	< 1	%	‡632,820 shares common stock (acquired 8-27-99)	220,000	14,042,276
iMEMORIES, INC. Scottsdale, Arizona	27.2	%	10% convertible promissory note, due 2012 (acquired 9-13-10)	1,000,000	1,000,000

Enables online video and photo sharing and DVD creation for home movies recorded in analog and new digital format.					
			17,391,304 shares Series B Convertible Preferred Stock, convertible into 17,391,304 shares of common stock at $0.23 per share (acquired 7-10-09)	4,000,000	4,000,000
			Warrant to purchase 968,750 shares of common stock at $0.12 per share, expiring 2020 (acquired 9-13-10)	–	–
				5,000,000	5,000,000
KBI BIOPHARMA, INC. Durham, North Carolina Provides fully-integrated, outsourced drug development and bio-manufacturing services.	17.1	%	7,142,857 shares Series B-2 Convertible Preferred Stock, convertible into 10,204,082 shares of common stock at $0.49 per share (acquired 9-08-09)	5,000,000	4,200,000

†Publicly-owned company ¥ Control investment * Affiliated investment ‡Unrestricted securities as defined in Note (b)

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CAPITAL SOUTHWEST CORPORATION AND SUBSIDIARIES

CONSOLIDATED SCHEDULE OF INVESTMENTS

March 31, 2011

Company	Equity (a)		Investment (b)	Cost	Value (c)
¥MEDIA RECOVERY, INC. Dallas, Texas Computer datacenter and office automation supplies and accessories; impact, tilt monitoring and temperature sensing devices to detect mishandling shipments; dunnage for protecting shipments.	97.5	%	800,000 shares Series A Convertible Preferred Stock, convertible into 800,000 shares of common stock at $1.00 per share (acquired 11-4-97)	800,000	3,000,000
			4,000,002 shares common stock (acquired 11-4-97)	4,615,000	15,100,000
				5,415,000	18,100,000
*PALLETONE, INC. Bartow, Florida Manufacturer of wooden pallets and pressure-treated lumber.	8.4	%	12.3% senior subordinated notes, $2,000,000 principal due 2015 (acquired 9-25-06)	1,553,150	1,600,000
			150,000 shares common stock (acquired 10-18-01)	150,000	2
			Warrant to purchase 15,294 shares of common stock at $1.00 per share, expiring 2011 (acquired 2-17-06)	45,746	–
				1,748,896	1,600,002
¥†PALM HARBOR HOMES, INC. Dallas, Texas Integrated manufacturing, retailing, financing and insuring of manufactured housing and modular homes.	30.4	%	7,855,121 shares common stock (acquired 1-3-85 thru 7-31-95)	10,931,955	2
			Warrant to purchase 286,625 shares of common stock at $3.14 per share, expiring 2019 (acquired 4-24-09)	–	–
				10,931,955	2
PHI HEALTH, INC. Richardson, Texas Develops and sells cardiac MRI systems and software.	67.0	%	1,559,111 shares Series A-1 Convertible Preferred Stock convertible into 1,559,111 shares of common stock at $0.0015 per share (acquired 1-27-11)	2,339	2,339

	555,556 shares Series B-1 Convertible Preferred Stock convertible into 555,556 shares common stock at $2.25 per share (acquired 1-27-11)	1,250,000	1,250,000
	4,500,000 Shares Series C-1 Convertible Preferred Stock convertible into 4,500,000 shares common stock at $0.20 per share (acquired 1-7-11 and 1-27-11)	4,500,000	4,500,000
		5,752,339	5,752,339

†Publicly-owned company ¥ Control investment * Affiliated investment ‡Unrestricted securities as defined in Note (b)

The accompanying Notes are an integral part of these Consolidated Financial Statements

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CAPITAL SOUTHWEST CORPORATION AND SUBSIDIARIES

CONSOLIDATED SCHEDULE OF INVESTMENTS

March 31, 2011

Company	Equity (a)		Investment (b)	Cost	Value (c)
¥THE RECTORSEAL CORPORATION Houston, Texas Specialty chemicals for plumbing, HVAC, electrical, construction, industrial, oil field and automotive applications; smoke containment systems for building fires; also owns 20% of The Whitmore Manufacturing Company.	100.0	%	27,907 shares common stock (acquired 1-5-73 and 3-31-73)	52,600	144,700,000
TCI HOLDINGS, INC. Denver, Colorado Cable television systems and microwave relay systems.	–		21 shares 12% Series C Cumulative Compounding Preferred Stock (acquired 1-30-90)	–	840,778
†TEXAS CAPITAL BANCSHARES, INC. Dallas, Texas Regional bank holding company with banking operations in six Texas cities.	1.6	%	‡489,656 shares common stock (acquired 5-1-00)	3,550,006	12,711,470
TRAX HOLDINGS, INC. Scottsdale, Arizona Provides a comprehensive set of solutions to improve the transportation validation, accounting, payment and information management process.	30.7	%	1,061,279 shares Series A Convertible Preferred Stock, convertible into 1,077,203 common stock at $4.64 per share (acquired 12-8-08 and 2-17-09)	5,000,000	5,758,030
VIA HOLDINGS, INC. Sparks, Nevada Designer, manufacturer and distributor of high-quality office seating.	28.1	%	12,686 shares common stock (acquired 3-4-11 and 3-25-11)	4,926,290	4
*WELLOGIX, INC. Houston, Texas Developer and supporter of software used by the oil and gas industry.	19.2	%	4,788,371 shares Series A-1 Convertible Participating Preferred Stock, convertible into 4,788,371 shares of common stock at $1.0441 per share (acquired 8-19-05 thru 6-15-08)	5,000,000	2
	80.0	%		1,600,000	55,600,000

¥THE WHITMORE MANUFACTURING COMPANY Rockwall, Texas Specialized surface mining, railroad and industrial lubricants; coatings for automobiles and primary metals; fluid contamination control devices.		80 shares common stock (acquired 8-31-79)		
MISCELLANEOUS	–	Ballast Point Ventures II, L.P. 2.2% limited partnership interest (acquired 8-4-08 thru 6-18-10)	1,200,000	1,200,000

†Publicly-owned company ¥ Control investment * Affiliated investment ‡Unrestricted securities as defined in Note (b)

The accompanying Notes are an integral part of these Consolidated Financial Statements

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CAPITAL SOUTHWEST CORPORATION AND SUBSIDIARIES

CONSOLIDATED SCHEDULE OF INVESTMENTS

March 31, 2011

Company	Equity (a)	Investment (b)	Cost	Value (c)
MISCELLANEOUS (continued)	–	BankCap Partners Fund I, L.P. 5.5% limited partnership interest (acquired 7-14-06 thru 12-13-10)	5,762,270	5,101,727
	–	CapitalSouth Partners Fund III, L.P. 1.9% limited partnership interest (acquired 1-22-08 and 2-12-09)	831,256	790,000
	100.0 %	¥CapStar Holdings Corporation 500 shares common stock (acquired 6-10-10)	3,703,619	4,380,481
	–	Diamond State Ventures, L.P. 1.4% limited partnership interest (acquired 10-12-99 thru 8-26-05)	76,000	177,996
	–	¥Discovery Alliance, LLC 90.0% limited liability company (acquired 9-12-08 thru 5-14-10)	900,000	574,488
	–	Essex Capital Corporation 10% unsecured promissory note due 8-19-10 (acquired 8-16-09)	–	1,000,000
	–	First Capital Group of Texas III, L.P. 3.0% limited partnership interest (acquired 12-26-00 thru 8-12-05)	778,894	407,731
	100 %	¥Humac Company 1,041,000 shares common stock (acquired 1-31-75 and 12-31-75)	–	166,000

	–	STARTech Seed Fund I 12.1% limited partnership interest (acquired 4-17-98 thru 1-5-00)	178,066	52,606
	–	STARTech Seed Fund II 3.2% limited partnership interest (acquired 4-28-00 thru 2-23-05)	843,891	317,392
	–	Sterling Group Partners I, L.P. 1.6% limited partnership interest (acquired 4-20-01 thru 1-24-05)	1,064,042	919,417
TOTAL INVESTMENTS			$ 98,354,060	$ 489,272,655

†Publicly-owned company ¥ Control investment * Affiliated investment ‡Unrestricted securities as defined in Note (b)

The accompanying Notes are an integral part of these Consolidated Financial Statements

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Notes to Consolidated Schedule of Investments

(a) Equity

The percentages in the "Equity" column express the potential equity interests held by Capital Southwest Corporation and Capital Southwest Venture Corporation (together, the "Company") in each issuer. Each percentage represents the amount of the issuer's common stock the Company owns or can acquire as a percentage of the issuer's total outstanding common stock, plus stock reserved for all warrants, convertible securities and employee stock options.

(b) Investments

Unrestricted securities (indicated by ±) are freely marketable securities having readily available market quotations. All other securities are restricted securities, which are subject to one or more restrictions on resale and are not freely marketable. At September 30, 2011, restricted securities represented approximately 95.3% of the value of the consolidated investment portfolio.

Our investments are carried at fair value in accordance with the Investment Company Act of 1940 (the "1940 Act") and FASB Accounting Standards Codification™ (ASC) Topic 820, Fair Value Measurements and Disclosures. In accordance with the 1940 Act, unrestricted minority-owned publicly traded securities, for which the market quotations are readily available, are valued at the closing sale price for the NYSE listed securities and the lower of the closing bid price or the last sale price for NASDAQ securities on the valuation date; and restricted publicly traded securities and other privately held securities are valued as determined in good faith by our Board of Directors.

ASC Topic 820 defines fair value in terms of the price that would be received upon the sale of an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date (the "exit price") and excludes transaction costs. Under ASC Topic 820, the fair value measurement also assumes that the transaction to sell an asset occurs in the principal market for the asset or, in the absence of a principal market, the most advantageous market for the asset. The principal market is the market in which the reporting entity would sell or transfer the asset with the greatest volume and level of activity for the asset. In determining the principal market for an asset or liability under ASC Topic 820, it is assumed that the reporting entity has access to the market as of the measurement date.

(c) Value

Debt Securities are generally valued on the basis of the price the security would command in order to provide a yield-to-maturity equivalent to the present yield of comparable debt instruments of similar quality. Issuers whose debt securities are judged to be of poor quality and doubtful collectability may instead be valued by assigning percentage discounts commensurate with the quality of such debt securities. Debt securities may also be valued based on the resulting value from the sale of the business at the estimated fair market value.

Partnership Interests, Preferred Equity and Common Equity, including unrestricted marketable securities are valued at the closing sale price for the NYSE listed securities and the lower of the closing bid price or the last sale price for NASDAQ securities on the valuation date, and restricted marketable securities for which there is a public market are valued at the closing sale price for the NYSE listed securities and the lower of the closing bid price or the last sale price for NASDAQ securities on the valuation date adjusted in good faith by our Board of Directors if they deem a discount or premium would be likely or obtainable upon a sale or transfer of our interest. For those without a principal market, the Board of Directors considers the financial condition and operating results of the issuer; the long-term potential of the business of the issuer; the market for and recent sales prices of the issuer's securities; the values of similar securities issued by companies in similar businesses; the proportion of the issuer's securities owned by the Company; protective put analysis based on the Black-Scholes option pricing model; the nature and duration of resale restrictions; and the nature of any rights enabling the Company to require the issuer to register restricted securities under applicable securities laws. In determining the fair value of restricted securities, the Board of Directors considers the inherent value of such securities without regard to the restrictive feature and adjusts for any diminution in value resulting from restrictions on resale. Investments in certain entities that calculate net asset value per share (or its equivalent) and for which fair market value is not readily determinable, are valued using the net asset value per share (or its equivalent, such as member units or ownership interest in partners' capital to which a proportionate share of net assets is attributed) of the investment.

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Equity Warrants are valued using the Black-Scholes model which defines the fair value of a warrant in relation to the market price of its common stock, share price volatility, and time to maturity.

(d) Agreements Between Certain Issuers and the Company

Agreements between certain issuers and the Company provide that the issuer will bear substantially all costs in connection with the disposition of common stock, including those costs involved in registration under the Securities Act of 1933, but excluding underwriting discounts and commissions. These agreements cover common stock owned at September 30, 2011 and common stock which may be acquired thereafter through the exercise of warrants and conversion of debentures and preferred stock. They apply to restricted securities of all issuers in the investment portfolio of the Company except securities of the following issuers which are not obligated to bear registration costs: Humac Company and The Whitmore Manufacturing Company.

(e) Descriptions and Ownership Percentages

The descriptions of the companies and ownership percentages shown in the Consolidated Schedule of Investments were obtained from published reports and other sources believed to be reliable. Acquisition dates indicated are the dates specific securities were acquired, which may differ from the original investment dates. Certain securities were received in exchange for or upon conversion or exercise of other securities previously acquired.

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Notes to Consolidated Financial Statements

1. ORGANIZATION AND BASIS OF PRESENTATION

Organization

Capital Southwest Corporation (“CSC” or the “Company”) was organized as a Texas corporation on April 19, 1961. Until September 1969, we operated as a licensee under the Small Business Investment Act of 1958. At that time, we transferred to our wholly-owned subsidiary, Capital Southwest Venture Corporation ("CSVC") certain assets and our license as a small business investment company ("SBIC"). CSVC is a closed-end, non-diversified investment company of the management type registered under the Investment Company Act of 1940 (the “1940 Act”). Prior to March 30, 1988, we were registered as a closed-end, non-diversified investment company under the 1940 Act. On that date, we elected to become a Business Development Company (“BDC”) subject to the provisions of the 1940 Act, as amended by the Small Business Incentive Act of 1980. Because we wholly own CSVC, the portfolios of both entities are referred to collectively as “our,” “we” and “us.” Capital Southwest Management Company (“CSMC”), a wholly-owned subsidiary of CSC, is the management company for CSC and CSVC. CSMC generally incurs all normal operating and administrative expenses, including but not limited to, salaries and related benefits, rent, equipment and other administrative costs required for its day-to-day operations.

Our portfolio is a composite of companies, consisting of companies in which we have controlling interests, developing companies and marketable securities of established publicly traded companies. We make available significant managerial assistance to the companies in which we invest and believe that providing managerial assistance to such investee companies is critical to their business development activities. CSMC receives a monthly fixed fee for management services provided to certain of its control portfolio companies.

Basis of Presentation

The consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America (GAAP). Under rules and regulations applicable to investment companies, we are precluded from consolidating any entity other than another investment company. An exception to this general principle occurs if the investment company has an investment in an operating company that provides services to the investment company. Accordingly, consolidated financial statements include our management company.

The financial statements included herein have been prepared in accordance with GAAP for interim financial information and the instructions to Form 10-Q and Article 6 of Regulations S-X. The financial statements should be read in conjunction with the consolidated financial statements and notes thereto included in our Form 10-K for the year ended March 31, 2011, as filed with the Securities and Exchange Commission (SEC). Certain information and footnotes normally included in financial statements prepared in accordance with GAAP have been condensed or omitted, although we believe that the disclosures are adequate for a fair presentation. The information reflects all adjustments (consisting of normal recurring adjustments) which are, in the opinion of management, necessary for a fair presentation of the results of operations for the interim period.

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Portfolio Investment Classification

We classify our investments in accordance with the requirements of the 1940 Act. Under the 1940 Act, "Control Investments" are defined as investments in which we own more than 25% of the voting securities or have rights to maintain greater than 50% of the board representation; "Affiliated Investments" are defined as investments in which we own between 5% and 25% of the voting securities; and "Non-Control/Non-Affiliated Investments" are defined as investments that are neither "Control Investments" nor "Affiliated Investments."

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

The following is a summary of significant accounting policies followed in the preparation of the consolidated financial statements of CSC, CSVC and CSMC.

Fair Value Measurements The Company adopted FASB ASC Topic 820 on April 1, 2008. ASC Topic 820 (1) creates a single definition of fair value, (2) establishes a framework for measuring fair value, and (3) expands disclosure requirements about items measured at fair value. The Statement applies to both items recognized and reported at fair value in the financial statements and items disclosed at fair value in the notes to the financial statements. The Statement does not change existing accounting rules governing what can or what must be recognized and reported at fair value in the Company's financial statements, or disclosed at fair value in the Company's notes to the financial statements. Additionally, ASC Topic 820 does not eliminate practicability exceptions that exist in accounting pronouncements amended by this Statement when measuring fair value.

Fair value is generally determined based on quoted market prices in the active markets for identical assets or liabilities. If quoted market prices are not available, we use valuation techniques that place greater reliance on observable inputs and less reliance on unobservable inputs. Due to the inherent uncertainty in the valuation process, our estimate of fair value may differ materially from the values that would have been used had a ready market for the securities existed. In addition, changes in the market environment, portfolio company performance and other events may occur over the lives of the investments that may cause the gains or losses ultimately realized on these investments to be materially different than the valuations currently assigned. We determine the fair value of each individual investment and recorded changes in fair value as unrealized appreciation or depreciation.

Pursuant to our internal valuation process, each portfolio company is valued once a quarter. In addition to our internal valuation process, our Board of Directors retains a nationally recognized firm to provide limited scope third party valuation services on certain portfolio investments. Our Board of Directors retained Duff & Phelps to provide limited scope third party valuation services on six investments comprising 78% of our net asset value at March 31, 2011. For full disclosure of Duff & Phelps' services, see page 5 of our Annual Report on Form 10-K under the heading "Determination of Net Asset Value and Portfolio Valuation Process."

We believe our investments at September 30, 2011 and March 31, 2011 approximate fair value as of those dates based on the market in which we operate and other conditions in existence at those reporting periods.

Investments Investments are stated at fair value determined by our Board of Directors as described in Notes to the Consolidated Schedule of Investments and Note 3 below. The average cost method is used in determining cost of investments sold. Investments are recorded on a trade date basis.

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Cash and Cash Equivalents Cash and cash equivalents consist of highly liquid investments with an original maturity of three months or less at the date of purchase. Cash and cash equivalents are carried at cost, which approximates fair value.

Segment Information The Company operates and manages its business in a singular segment. As an investment company, the Company invests in portfolio companies in various industries and geographic areas as presented in the Consolidated Schedule of Investments.

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

Interest and Dividend Income Interest and dividend income is recorded on an accrual basis to the extent amounts are expected to be collected. Dividend income is recorded at the ex-dividend date for marketable securities and restricted securities. In accordance with our valuation policy, accrued interest and dividend income is evaluated periodically for collectability. When a debt or loan becomes 90 days or more past due, and if we otherwise do not expect the debtor to be able to service all of its debt or other obligations, we will generally establish a reserve against the interest income, thereby placing the loan or debt security's status on non-accrual basis, and cease to recognize interest income on that loan or debt security until the borrower has demonstrated the ability and intent to pay contractual amounts due. If a loan or debt security's status significantly improves regarding ability to service debt or other obligations, it will be restored to accrual basis.

Federal Income Taxes CSC and CSVC have elected and intend to comply with the requirements of the Internal Revenue Code (IRC) necessary to qualify as regulated investment companies (RICs). By meeting these requirements, they will not be subject to corporate federal income taxes on ordinary income distributed to shareholders. In order to comply as a RIC, each company is required to timely distribute to its shareholders at least 90% of investment taxable income, as defined by the IRC, each year. Taxable income generally differs from net income for financial reporting purposes due to temporary and permanent differences in the recognition of income and expenses. Taxable income generally excludes net unrealized appreciation or depreciation, as investment gains and losses are not included in taxable income until they are realized. The Company's policy is to retain and pay the 35% corporate tax on realized long-term capital gains. For investment companies that qualify as RICs under the IRC, federal income taxes payable on security gains that the Company elects to retain are accrued only on the last day of our tax year, December 31. See Note 4 for further discussion.

CSMC, a wholly owned subsidiary of CSC, is not a RIC and is required to pay taxes at the current corporate rate.

We account for interest and penalties as part of operating expenses. There were no interest or penalties incurred during the six months ended September 30, 2011 and 2010.

Deferred Taxes CSMC sponsors a qualified defined benefit pension plan which covers its employees and employees of certain of its controlled affiliates. Deferred taxes related to the qualified defined benefit pension plan are recorded as incurred.

Stock-Based Compensation We account for our stock-based compensation using the fair value method, as prescribed by ASC 718, Compensation – Stock Compensation. Accordingly, we recognize stock-based compensation cost over the straight-line method for all share-based payments granted on or after that date and for all awards granted to employees prior to April 1, 2006 that remain unvested on that date. The fair value of stock options is determined on the date of grant using the Black-Scholes pricing model and is expensed over the vesting period of the related stock options. See Note 6 for further discussion.

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Defined Pension Benefits and Other Postretirement Plans We record annual amounts relating to the defined benefit pension plan based on calculations, which include various actuarial assumptions such as discount rates and assumed rates of return depending on the pension plan. Material changes in pension costs may occur in the future due to changes in the discount rate, changes in the expected long-term rate of return, changes in level of contributions to the plans and other factors. The funded status is the difference between the fair value of plan assets and the benefit obligation. We recognize changes in the funded status of defined benefit plan in the Statement of Assets and Liabilities in the year in which the changes occur and measure defined benefit plan assets and obligations as of the date of the employer's fiscal year-end. We presently use March 31 as the measurement date for our defined benefit plan.

Concentration of Risk We place our idle cash in financial institutions, and at times, such balances may be in excess of the federally insured limits. On 11/19/2010, the FDIC issued a Final Rule implementing section 434 of the Dodd-Frank Wall Street Reform and Consumer Protection Act that provides for unlimited insurance coverage of noninterest bearing transaction accounts beginning December 31, 2010 and continuing through December 31, 2012.

Recent Accounting Pronouncements

ASU No. 2011-04, Fair Value Measurements (Topic 820): Amendments to Achieve Common Fair Value Measurement and Disclosure Requirements in U.S. GAAP and IFRSs.   In May 2011, the FASB issued ASU 2011-04 "Amendments to Achieve Common Fair Value Measurement and Disclosure Requirements in U.S. GAAP and IFRSs," which results in common fair value measurement and disclosure requirements in U.S. GAAP and IFRSs. ASU 2011-04 is effective for interim and annual reporting periods beginning after December 15, 2011. Adoption of ASU 2011-04 is not expected to have a significant impact on the Company's financial statement disclosures.

3. INVESTMENTS

We record our investments at fair value as determined in good faith by our Board of Directors in accordance with GAAP. When available, we base the fair value of our investments on directly observable market prices or on market data derived for comparable assets. For all other investments, inputs used to measure fair value reflect management's best estimate of assumptions that would be used by market participants in pricing the investments in a hypothetical transaction.

The levels of fair value inputs used to measure our investments are characterized in accordance with the fair value hierarchy established by ASC. We use judgment and consider factors specific to the investment in determining the significance of an input to a fair value measurement. While management believes our valuation methodologies are appropriate and consistent with market participants, the use of different methodologies or assumptions to determine the fair value of certain financial instruments could result in a different estimate of fair value at the reporting date. The three levels of the fair value hierarchy and investments that fall into each of the levels are described below:

- Level 1: Investments whose values are based on unadjusted quoted prices in active markets for identical assets or liabilities that the Company has the ability to access. We use Level 1 inputs for publicly traded unrestricted securities. Such investments are valued at the closing price for listed securities and at the lower of the closing bid price or the closing sale price for over-the-counter (NASDAQ) securities on the valuation date.

- Level 2: Investments whose values are based on observable inputs other than quoted prices included in Level 1 that are observable for the asset or liability, either directly or indirectly. These inputs may include quoted prices for the identical instrument in non-active markets, quoted prices for similar instruments in active markets and similar data. We did not value any of our investments using Level 2 inputs as of June 30, 2011 and 2010.

- Level 3: Investments whose values are based on prices or valuation techniques that require inputs that are both unobservable and significant to the overall fair value measurement. These inputs reflect management's own assumptions about the assumptions a market participant would use in pricing the investment. We use Level 3 inputs for measuring the fair value of substantially all of our investments. See "Notes to Consolidated Schedule of Investments" (c) on page 18 for the investment policy used to determine the fair value of these investments.

As required by ASC 820, when the inputs used to measure fair value fall within different levels of the hierarchy, the level within the fair value measurement is categorized based on the lowest level input that is significant to the fair value measurement which may include inputs that are observable (Levels 1 and 2) and unobservable (Level 3). Therefore, gains and losses for such investments categorized within the Level 3 table below may include changes in fair value that are attributable to both observable inputs (Levels 1 and 2) and unobservable (Level 3). We conduct reviews of fair value hierarchy classifications on a quarterly basis. Changes in the observability of valuation inputs may result in a reclassification of certain investments.

As of September 30, 2011 and March 31, 2011, 95.3% and 94.5%, respectively, of our portfolio investments were categorized as Level 3.

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The following fair value hierarchy tables set forth our investment portfolio by level as of September 30, 2011 and March 31, 2011 (in millions):

		Fair Value Measurements at 9/30/11 Using		
Asset Category	Total	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Debt	$15.3	$–	$–	$ 15.3
Partnership Interests	9.9	–	–	9.9
Preferred Equity	31.8	–	–	31.8
Common Equity	386.9	20.8	–	366.1
Total Investments	$443.9	$20.8	$–	$ 423.1

		Fair Value Measurements at 3/31/11 Using		
Asset Category	Total	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Debt	$12.7	$–	$–	$ 12.7
Partnership Interests	9.5	–	–	9.5
Preferred Equity	45.8	–	–	45.8
Common Equity	421.3	26.8	–	394.5
Total Investments	$489.3	$26.8	$–	$ 462.5

The following table provides a summary of changes in the fair value of investments measured using Level 3 inputs during the six months ended September 30, 2011 (in millions):

	Fair Value 3/31/11	Net Unrealized Appreciation (Depreciation)	Net Changes from Unrealized to Realized	New / Add-On Invest-ments	Divesti-tures	Fair Value 9/30/11
Debt	$12.7	$ (0.1)	$(2.0)	$5.7	$(1.0)	$15.3
Partnership Interest	9.5	–	–	0.4	–	9.9
Preferred Equity	45.8	(14.2)	–	6.3	(6.1)	31.8
Common Equity	394.5	(19.2)	(9.2)	–	–	366.1
Total Investments	$462.5	$ (33.5)	$(11.2)	$12.4	$(7.1)	$423.1

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The following table provides a summary of changes in the fair value of investments measured using Level 3 inputs during the quarter ended September 30, 2011 (in millions):

	Fair Value 6/30/11	Net Unrealized Appreciation (Depreciation)	Net Changes from Unrealized to Realized	New / Add-On Invest-ments	Divesti-tures	Fair Value 9/30/11
Debt	$17.0	$ (0.3)	$(2.0)	$1.6	$(1.0)	$15.3
Partnership Interest	10.1	(0.2)	–	–	–	9.9
Preferred Equity	42.8	(11.9)	–	1.1	(0.2)	31.8
Common Equity	393.2	(17.9)	(9.2)	–	–	366.1
Total Investments	$463.1	$ (30.3)	$(11.2)	$2.7	$(1.2)	$423.1

The total unrealized gains (losses) included in earnings that related to assets still held at report date for the six months ended September 30, 2011 and 2010 were ($36,784,513) and $24,106,929, respectively.

4. INCOME TAXES

We operate to qualify as a RIC under Subchapter M of the IRC. In order to qualify as a RIC, we must annually distribute at least 90% of our taxable ordinary income, based on our tax year, to our shareholders in a timely manner. Ordinary income includes net short-term capital gains but excludes net long-term capital gains. A RIC is not subject to federal income tax on the portion of its ordinary income and long-term capital gains that are distributed to its shareholders, including "deemed distributions" discussed below. As permitted by the Code, a RIC can designate dividends paid in the subsequent tax year as dividends of current year ordinary income and net long-term gains if those dividends are both declared by the extended due date of the RIC's federal income tax return and paid to shareholders by the last day of the subsequent tax year. We have a calendar tax year end of December 31.

We have distributed or intend to distribute sufficient dividends to eliminate taxable income for our completed tax years. If we fail to satisfy the 90% distribution requirement or otherwise fail to qualify as a RIC in any tax year, we would be subject to tax in such year on all of our taxable income, regardless of whether we made any distributions to our shareholders. For the tax year ended December 31, 2010 and 2009, we declared and paid ordinary dividends in the amount of $2,993,623 and $2,993,310, respectively.

Additionally, we are subject to a nondeductible federal excise tax of 4% if we do not distribute at least 98% of our investment company ordinary taxable income before the end of our tax year. For the tax years ended December 31, 2010 and 2009, we distributed 100% of our investment company ordinary taxable income. As a result, we have made no tax provisions for income taxes on ordinary taxable income for the tax years ended December 31, 2010 and 2009.

A RIC may elect to retain its long-term capital gains by designating them as "deemed distribution" to its shareholders and paying a federal tax rate of 35% on the long-term capital gains for the benefit of its shareholders. Shareholders then report their share of the retained capital gains on their income tax returns as if it had been received and report a tax credit for tax paid on their behalf by the RIC. Shareholders then add the amount of the "deemed distribution" net of such tax, to the basis of their shares.

- For the tax year ended December 31, 2010, we had net long-term capital gains of $70,221,589 for tax purposes and $70,325,930 for book purposes, which we elected to retain and treat as deemed distributions to our shareholders. During the quarter ended December 31, 2010 we recorded a $4,217,985 reduction in the gain on sale of Lifemark Group, Inc. This reduction was the result of a net asset adjustment calculated in accordance with the Stock Purchase Agreement signed on June 10, 2010.

- In order to make the election to retain capital gains, we incurred federal taxes on behalf of our shareholders in the amount of $24,577,557 for the tax year ended December 31, 2010. For the tax year ended December 31, 2009, we had net long-term capital gains of $2,327,150 for tax purposes and $1,682,616 for book purposes, which we elected to retain and treat as deemed distributions to our shareholders. In order to make the election to retain capital gains, we incurred federal taxes on behalf of our shareholders in the amount of $814,502 for the tax year ended December 31, 2009.

For the quarters ended September 30, 2011 and 2010, CSC and CSVC qualified to be taxed as RICs. We intend to meet the applicable qualifications to be taxed as a RIC in future years. Management feels it is probable that we will maintain our RIC status for a period longer than one year. However, either Company's ability to meet certain portfolio diversification requirements of RICs in future years may not be controllable by such company.

CSMC, a wholly owned subsidiary of CSC, is not a RIC and is required to pay taxes at the current corporate rate. The Company sponsors a qualified defined benefit pension plan which covers its employees and employees of certain of its wholly owned portfolio companies. Deferred taxes related to the qualified defined pension plan are recorded as incurred.

5. ACCUMULATED NET REALIZED GAIN (LOSS)

Distributions made by RICs often differ from aggregate GAAP-basis undistributed net investment income and accumulated net realized gains (total GAAP-basis net realized gains). The principal cause is that required minimum fund distributions are based on income and gain amounts determined in accordance with federal income tax regulations, rather than GAAP. The differences created can be temporary, meaning that they will reverse in the future, or they can be permanent. In subsequent periods, when all or a portion of a temporary difference becomes a permanent difference, the amount of the permanent difference will be reclassified to "additional capital."

We incur federal taxes on behalf of our shareholders as a result of our election to retain long-term capital gains. As of September 30, 2011 we had accumulated long-term capital gains of $5,575,998; however, as of March 31, 2011 we had accumulated long-term capital losses of $6,863,347.

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6. EMPLOYEE STOCK OPTION PLANS

On July 20, 2009, shareholders approved the Company's 2009 Stock Incentive Plan (the "2009 Plan"), which provides for the granting of stock options to employees and officers of the Company and authorizes the issuance of common stock upon exercise of such options for up to 140,000 shares. All options are granted at or above market price, generally expire up to ten years from the date of grant and are generally exercisable on or after the first anniversary of the date of grant in five annual installments. The following table illustrates the number of options granted since the 2009 Plan was approved:

Date of Grant	Number of Options Granted	Exercise Price (market price at time of grant)
July 18, 2011	10,000	$ 96.92
July 19, 2010	15,000	$ 88.20
March 22, 2010	20,000	$ 95.79
October 19, 2009	38,750	$ 76.74

All 83,750 options remain outstanding, thus leaving 56,250 options available for grant under the plan as of September 30, 2011.

The Company previously granted stock options under its 1999 Stock Option Plan (the "1999 Plan"), as approved by shareholders on July 19, 1999. The 1999 Plan expired on April 19, 2009. Options previously made under the Company's 1999 Stock Option Plan and outstanding on July 20, 2009 continue in effect governed by provisions of the 1999 plan. All options granted under the 1999 Plan were granted at or above market price, generally expire up to ten years from the date of grant and are generally exercisable on or after the first anniversary of the date of grant in five to ten annual installments.

We recognize compensation cost over the straight-line method for all share-based payments granted on or after that date and for all awards granted to employees prior to April 1, 2006 that remain unvested on that date. The fair value of stock options are determined on the date of grant using the Black-Scholes pricing model and are expensed over the vesting period of the related stock options. Accordingly, for the quarters ended September 30, 2011 and 2010, we recognized compensation expense of $258,573 and $223,217 respectively.

As of September 30, 2011, the total remaining unrecognized compensation cost related to non-vested stock options was $2,620,506, which will be amortized over the remaining weighted average service period of approximately 3.0 years.

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The following table summarizes the 2009 Plan and the 1999 Plan price per option at grant date using the Black-Scholes pricing model:

		Black-Scholes Pricing Model Assumptions			
Date of Issuance	Weighted Average Fair Value	Expected Dividend Yield	Risk-Free Interest Rate	Expected Volatility	Expected Life (in years)
2009 Plan					
July 18,2011	$33.07	0.83 %	1.45 %	40.0 %	5
July 19, 2010	$28.59	0.91 %	1.73 %	37.5 %	5
March 22, 2010	$32.56	0.84 %	2.43 %	37.8 %	5
October 19, 2009	$25.36	1.04 %	2.36 %	37.6 %	5
1999 Plan					
July 30, 2008	$29.93	0.62 %	3.36 %	20.2 %	5
July 21, 2008	$27.35	0.67 %	3.41 %	20.2 %	5
July 16, 2007	$41.78	0.39 %	4.95 %	19.9 %	5
July 17, 2006	$33.05	0.61 %	5.04 %	21.2 %	7
May 15, 2006	$31.28	0.64 %	5.08 %	21.1 %	7

The following table summarizes activity in the 2009 Plan and the 1999 Plan as of June 30, 2011:

	Number of Shares	Weighted Average Exercise Price
2009 Plan		
Balance at March 31, 2010	58,750	$83.23
Granted	15,000	88.20
Exercised	–	–
Canceled	–	–
Balance at March 31, 2011	73,750	$84.24
Granted	10,000	96.92
Exercised	–	–
Canceled	–	–
Balance at September 30, 2011	83,750	$85.75
1999 Plan		
Balance at March 31, 2010	107,900	$114.78
Granted	–	–
Exercised	(11,400)	65.37
Canceled	–	–
Balance at March 31, 2011	96,500	$114.78
Granted	–	–
Exercised	(1,500)	65.70
Canceled	–	–
Balance at September 30, 2011	95,000	$113.63
Combined Balance at September 30, 2011	178,750	$104.74

September 30, 2011	Weighted Average Remaining Contractual Term	Aggregate Intrinsic Value
Outstanding	3.0 years	$ 5,382,148
Exercisable	2.5 years	$ 2,404,662

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At September 30, 2011, the range of exercise prices and weighted-average remaining contractual life of outstanding options was $76.74 to $152.98 and 3.1 years, respectively. The number of options exercisable under the 2009 Plan and the 1999 Plan, at September 30, 2011, was 75,840 with a weighted-average exercise price of $116.75. There were 1,500 options exercised and new share issued for $98,550 in cash during the quarter ended September 30, 2011 and 782 options exercised and new shares issued for $51,377 in cash during the quarter ended September 30, 2010.

7. COMMITMENTS

From time to time the Company may be liable for claims against its portfolio companies. We do not believe the effects of such claims would have a material impact on our results of operations and financial condition.

CSC has agreed, subject to certain conditions, to invest up to $9,885,365 in nine portfolio companies.

8. SUMMARY OF PER SHARE INFORMATION

The following presents a summary of per share data for the six and three months ended September 30, 2011 and 2010.

	Three Months Ended September 30,		Six Months Ended September 30	
Per Share Data	2011	2010	2011	2010
Investment income	$ .34	$ .31	$ .65	$ 1.10
Operating expenses	(.32)	(.28)	(.63)	(.54)
Income taxes	(.01)	(.01)	(.01)	(.01)
Net investment income	.01	.02	.01	.55
Distributions from undistributed net investment income	–	–	(.40)	(.40)
Net realized gain net of tax	4.88	.14	3.31	19.92
Net increase (decrease) in unrealized appreciation of investments	(11.74)	6.24	(12.95)	(11.32)
Exercise of employee stock options	(.03)	(.01)	(.03)	(.01)
Stock option expense	.07	.07	.13	.11
Increase (decrease) in net asset value	(6.81)	6.46	(9.93)	8.85
Net asset value				
Beginning of period	140.56	132.53	143.68	130.14
End of period	$ 133.75	$ 138.99	$ 133.75	$ 138.99

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Item 2. – Management's Discussion and Analysis of Financial Condition and Results of Operations

The following discussion should be read in conjunction with our financial statements and the notes thereto included elsewhere in this Annual Report on Form 10-K.

The information contained herein may contain “forward-looking statements” based on our current expectations, assumptions and estimates about us and our industry. These forward-looking statements involve risks and uncertainties. Words such as “believe,” “anticipate,” “estimate,” “expect,” “intend,” “plan,” “will,” “may,” “might,” “could,” “ other similar expressions identify forward-looking statements. In addition, any statements that refer to expectations, projections or other characterizations of future events or circumstances are forward-looking statements. Our actual results could differ materially from those anticipated in the forward-looking statements as a result of several factors more fully described in “Risk Factors” and elsewhere in this Form 10-Q, and in our Form 10-K for the year ended March 31, 2011, filed with the SEC on June 10, 2011. The forward-looking statements made in this Form 10-Q related only to events as of the date on which the statements are made. You should read the following discussion in conjunction with the consolidated financial statements and related footnotes and other financial information included in the Annual Report on Form 10-K for the year ended March 31, 2011. We undertake no obligation to update publicly any forward-looking statements for any reason, even if new information becomes available or other events occur in the future.

Results of Operations

The composite measure of our financial performance in the Consolidated Statements of Operations is captioned “Increase in net assets from operations” and consists of three elements. The first is “Net investment income,” which is the difference between income from interest, dividends and fees and its combined operating and interest expenses, net of applicable income taxes. The second element is “Net realized gain (loss) on investments,” which is the difference between the proceeds received from disposition of portfolio securities and their stated cost, net of applicable income tax expense based on the Company’s tax year. The third element is the “Net increase in unrealized appreciation of investments,” which is the net change in the market or fair value of the Company’s investment portfolio, compared with stated cost. It should be noted that the “Net realized gain (loss) on investments” and “Net increase in unrealized appreciation of investments” are directly related in that when an appreciated portfolio security is sold to realize a gain, a corresponding decrease in net unrealized appreciation occurs by transferring the gain associated with the transaction from being “unrealized” to being “realized.” Conversely, when a loss is realized on a depreciated portfolio security, an increase in net unrealized appreciation occurs.

Net Investment Income

For the six months ended September 30, 2011, total investment income was $2,454,113, a $1,769,898, or 40.6%, decrease from the $4,130,354 total investment income for the six months ended September 30, 2010. This comparable period decrease was primarily attributable to a $1,768,194 or 59.7% decrease in dividend income and partially offset by a $192,589 or 26.6% increase in portfolio securities interest.

The Company’s principal objective is to achieve capital appreciation. Therefore, a significant portion of the investment portfolio is structured to maximize the potential return from equity participation and provides minimal current yield in the form of interest or dividends. The Company also earns interest income from the short-term investment of cash funds, and the annual amount of such income varies based upon the average level of funds invested during the year and fluctuations in short-term interest rates. During the six months ended September 30, 2011 and 2010, respectively the Company also had interest income of $20,423 and $26,009 from temporary cash investments.

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The Company also receives management fees primarily from its controlled affiliates which aggregated $276,150 and $367,400 for the six months ended September 30, 2011 and 2010, respectively.

During the six months ended September 30, 2011 and 2010, the Company recorded dividend income from the following sources:

	Six Months Ended September 30,	
	2011	2010
Alamo Group, Inc.	$339,756	$339,636
Balco, Inc.	–	1,817,503
CapitalSouth Partners Fund III	49,189	–
Encore Wire Corporation	163,470	163,470
The RectorSeal Corporation	480,000	480,000
TCI Holdings, Inc.	40,635	40,635
The Whitmore Manufacturing Company	120,000	120,000
	$1,193,050	$2,961,244

Due to the nature of its business, the majority of the Company's operating expenses are related to employee and director compensation, office expenses, legal, professional and accounting fees and the net pension benefit. Total operating expenses, increased by $332,321 or 16.3% during the six months ended September 30, 2011 and 2010. The increase in 2011 is due primarily to higher salaries and bonuses paid, higher non-cash stock option expense, as well as an increase in professional fees related to divestitures.

Net Realized Gain (Loss) on Investments

During the six months ended September 30, 2011, we sold all of our shares of preferred stock (Series A, Series B and Series C) in Phi Health, Inc, generating net cash proceeds of $38,959 and a realized loss of $5,910,655; we sold all of our shares of Series A convertible preferred stock, along with warrants to purchase additional shares of common stock of All Components, Inc. in a management buy-out generating cash proceeds of $18,000,000 and a realized gain of $17,850,000; and we received $500,000 in cash proceeds from Essex Capital Corporation as settlement for an unsecured promissory note generating a gain of $500,000, which was the by-product of an option exercise agreement. In total, we recognized net realized gains of $12,439,345 for the six months ended September 30, 2011.

During the six months ended September 30, 2010, we sold all of our shares of common stock of Lifemark Group to NorthStar Memorial Group LLC resulting in net cash proceeds of $74,822,145 and $3,703,619 of real estate and assets, which were directly transferred to CapStar Holdings Corporation, our controlled affiliate created to hold assets transferred from Lifemark Group at time of sale. Transfer taxes in the amount of $1,218,855 related to the transfer of real estate were deducted from the realized gain on the Lifemark transaction. As a result of this transaction we recognized net realized gains on investments of $74,015,364 before taxes.

Management does not attempt to maintain a consistent level of realized gains from year to year, but instead attempts to maximize total investment portfolio appreciation. This strategy often dictates the long-term holding of portfolio securities in pursuit of increased values and increased unrealized appreciation, but may at opportune times dictate realizing gains or losses through the disposition of certain portfolio investments.

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Net Increase/(Decrease) in Unrealized Appreciation of Investments

For the six months ended September 30, 2011, we recognized a $48,634,453 decrease in net change in unrealized appreciate of investments. The largest decreases in unrealized appreciation are primarily attributable to our public holdings: Alamo Group, Inc., which decreased $14,825,575, Encore Wire Corporation, which decreased $13,281,938, and Heelys, Inc., which decreased $2,254,789. These decreases are a reflection of the decrease in the public markets that occurred this quarter. Other decreases include Cinatra Clean Technologies, Inc., which decreased $2,593,703, KBI Biopharma, Inc., which decreased $2,600,000, Media Recovery, Inc., which decreased $1,700,000 and The RectorSeal Corporation, which decreased $3,400,000 due to slowdowns in their respective business segments. Offsetting these decreases was The Whitmore Manufacturing Company, which increased $4,000,000 attributable to an increase in their earnings.

Set forth in the following table are the significant increases and decreases in unrealized appreciation by portfolio company:

	Three Months Ended September 30,		Six Months Ended September 30,	
	2011	2010	2011	2010
Alamo Group, Inc.	$(6,372,675)	$1,415,150	$(14,825,575)	$4,953,025
Cinatra Clean Technologies, Inc.	(2,593,703)	104,911	(2,593,703)	2,185,065
Encore Wire Corporation	(13,281,938)	6,130,125	(6,130,125)	–
Heelys, Inc.	(1,928,683)	–	(2,254,789)	279,520
KBI Biopharma, Inc.	–	–	(2,600,000)	–
Media Recovery, Inc.	2,500,000	1,500,000	(1,700,000)	2,700,000
Palm Harbor Homes, Inc.	–	(6,833,953)	–	(6,833,953)
The RectorSeal Corporation	(3,600,000)	8,100,000	(3,400,000)	17,900,000
The Whitmore Manufacturing Company	200,000	1,900,000	4,000,000	1,900,000

A description of the investments listed above and other material components of the investment portfolio are included elsewhere in this report under the caption “Consolidated Schedule of Investments – September 30, 2011 and March 31, 2011.”

Portfolio Investments

During the quarter ended September 30, 2011, we made investments of $1,678,469 in existing portfolio companies.

We have agreed, subject to certain conditions, to invest up to $9,885,365 in nine portfolio companies.

Financial Liquidity and Capital Resources

At September 30, 2011, the Company had cash and cash equivalents of approximately $53.3 million. Pursuant to the SBA regulations, cash and cash equivalents of $16.0 million held by CSVC may not be transferred or advanced to CSC without the consent of the SBA.

Management believes that the Company’s cash and cash equivalents and cash available from other sources described above are adequate to meet its expected requirements. Consistent with the long-term strategy of the Company, the disposition of investments from time to time may also be an important source of funds for future investment activities.

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Application of Critical Accounting Policies and Accounting Estimates

There have been no changes during the quarter ended September 30, 2011 to the critical accounting policies or the area that involves the use of significant judgments or estimates we described in our Annual Report on Form 10-K for the fiscal year ended March 31, 2011.

Item 3. Quantitative and Qualitative Disclosures About Market Risk

We are subject to financial market risks, including changes in marketable equity security prices. We do not use derivative financial instruments to mitigate any of these risks.

Our investment performance is a function of our portfolio companies' profitability, which may be affected by economic cycles, competitive forces, foreign currency fluctuations and production costs including labor rates, raw material prices and certain basic commodity prices. Most of the companies in our investment portfolio do not hedge their exposure to raw material and commodity price fluctuations. However, the portfolio company with the greatest exposure to foreign currency fluctuations generally hedges its exposure. All of these factors may have an adverse effect on the value of our investments and on our net asset value.

Our investment in portfolio securities includes fixed-rate debt securities which totaled $15,299,482 at September 30, 2011, equivalent to 3.4% of the value of our total investments. Generally, these debt securities are below investment grade and have relatively high fixed rates of interest; therefore, minor changes in market yields of publicly traded debt securities have little or no effect on the values of debt securities in our portfolio and no effect on interest income. Our investments in debt securities are generally held to maturity and their fair values are determined on the basis of the terms of the debt security and the financial condition of the issuer.

A portion of our investment portfolio consists of debt and equity securities of private companies. We anticipate little or no effect on the values of these investments from modest changes in public market equity valuations. Should significant changes in market valuations of comparable publicly traded companies occur, there may be a corresponding effect on valuations of private companies, which would affect the value and the amount and timing of proceeds eventually realized from these investments. A portion of our investment portfolio also consists of restricted common stocks of publicly traded companies. The fair values of these restricted securities are influenced by the nature of applicable resale restrictions, the underlying earnings and financial condition of the issuers of such restricted securities and the market valuations of comparable publicly traded companies. A portion of our investment portfolio also consists of unrestricted, freely marketable common stocks of publicly traded companies. These freely marketable investments, which are valued at the public market price, are directly exposed to equity price risks; in that a change in an issuer's public market equity price would result in an identical change in the value of our investment in such security.

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Item 4. Controls and Procedures

As of the end of the period covered by this report, an evaluation was performed under the supervision and with the participation of our management, including the Chairman of the Board and President and Chief Financial Officer, of the effectiveness of the design and operation of our disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) of the Securities Exchange Act of 1934). Based upon this evaluation, our Chairman of the Board and President, and Chief Financial Officer concluded that our disclosure controls and procedures are effective to ensure that the information required to be disclosed is recorded, processed, summarized and reported within the time periods specified in the Securities and Exchange Commission's rules and forms, and is accumulated and communicated to management, including the Chairman of the Board and President and Chief Financial Officer, as appropriate, to allow timely decisions regarding such required disclosure.

During the fiscal quarter ended September 30, 2011, there were no changes to the internal controls over financial reporting that have materially affected, or are reasonably likely to materially affect our internal control over financial reporting.

PART II. – OTHER INFORMATION

Item 1. Legal Proceedings

We may, from time to time, be involved in litigation arising out of our operations in the normal course of business or otherwise. Furthermore, third parties may try to seek to impose liability on us in connection with the activities of our portfolio companies. We have no current pending legal proceedings to which we are party or to which any of our assets is subject.

Item 1A. Risk Factors

There have been no material changes to our risk factors disclosed in Item 1A. "Risk Factors", in our Annual Report on Form 10-K for the fiscal year ended March 31, 2011.

Item 6. Exhibits

Exhibit No.	Description
31.1	Certification of Chairman of the Board and President required by Rule 13a-14(a) or Rule 15d-14(a) of the Securities Exchange Act of 1934, as amended (the "Exchange Act"), filed herewith.
31.2	Certification of Chief Financial Officer required by Rule 13a-14(a) or Rule 15d-14(a) of the Exchange Act, filed herewith.
32.1	Certification of Chairman of the Board and President required by Rule 13a-14(b) or Rule 15d-14(b) of the Exchange Act and Section 1350 of Chapter 63 of Title 18 of the United States Code, furnished herewith.
32.2	Certification of Chief Financial Officer required by Rule 13a-14(b) or Rule 15d-14(b) of the Exchange Act and Section 1350 of Chapter 63 of Title 18 of the United States Code, furnished herewith.
101.INS	XBRL Instance Document
101.SCH	XBRL Taxonomy Extension Schema Document
101.CAL	XBRL Taxonomy Extension Calculation Linkbase Document
101.DEF	XBRL Taxonomy Extension Definition Linkbase Document
101.LAB	XBRL Taxonomy Extension Label Linkbase Document
101.PRE	XBRL Taxonomy Extension Presentation Linkbase Document

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SIGNATURES

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

CAPITAL SOUTHWEST CORPORATION

October 28, 2011 Date	By:	/s/ Gary L. Martin Gary L. Martin Chairman of the Board and President
October 28, 2011 Date	By:	/s/ Tracy L. Morris Tracy L. Morris Chief Financial Officer

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