GILAT SATELLITE NETWORKS LTD
Form 20-F
April 07, 2009

As filed with the Securities and Exchange Commission on April 7, 2009

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 20-F

o **REGISTRATION STATEMENT PURSUANT TO SECTION 12(b) OR (g) OF THE SECURITIES EXCHANGE ACT OF 1934**

or

x **ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

For the fiscal year ended December 31, 2008

or

o **TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

For the transition period from __________ to __________

or

o **SHELL COMPANY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

Date of event requiring this shell company report ....

Commission file number: 0-21218

GILAT SATELLITE NETWORKS LTD.

(Exact name of Registrant as specified in its charter)

ISRAEL
(Jurisdiction of incorporation or organization)

Gilat House, 21 Yegia Kapayim Street, Kiryat Arye, Petah Tikva, 49130 Israel
(Address of principal executive offices)

Rachel Prishkolnik, +972-3- 9293020 (phone), +972-3-9252945 (fax)
Gilat House, 21 Yegia Kapayim Street, Kiryat Arye, Petah Tikva, 49130 Israel
(Name, Telephone, E-mail and/or Facsimile number and Address of Company Contact Person)

Securities registered or to be registered pursuant to Section 12(b) of the Act:

Title of each class	Name of each exchange on which registered
Ordinary Shares, NIS 0.20 Par Value	**NASDAQ Global Market**

Securities registered or to be registered pursuant of Section 12(g) of the Act: **None**

Securities for which there is a reporting obligation pursuant to Section 15(d) of the Act: **None**

Indicate the number of outstanding shares of each of the issuer s classes of capital or common stock at the close of the period covered by the annual report:

40,103,662 Ordinary Shares, NIS 0.20 par value per share.

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act.

Yes o No x

If this report is an annual or transition report, indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934.

Yes o No x

Indicate by check mark whether the Registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the Registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

Yes x No o

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of accelerated filer and large accelerated filer in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer o Accelerated filer x Non-accelerated filer o

Indicate by check mark the basis of accounting the registrant has used to prepare the financial statements included in this filing:

x U.S. Gaap

o International Financial Reporting Standards as issued by the International Accounting Standards Board

o Other

If Other has been checked in response to the previous question, indicate by check mark which financial statement the registrant has elected to follow.

Indicate by check mark which financial statement item the Registrant elected to follow:

Item 17 o Item 18 o

If this is an annual report, indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

Yes o No x

This report on Form 20-F is being incorporated by reference into our Registration Statements on Form S-8 (Registration Nos. 333-132649, 333-123410, 333-113932, 333-08826, 333-10092, 333-12466 and 333-12988).

INTRODUCTION

We are a leading global provider of Internet Protocol, or IP, based digital satellite communication and networking products and services. We design, produce and market VSATs, or very small aperture terminals, and related VSAT network equipment. VSATs are earth-based terminals that transmit and receive broadband, Internet, voice, data and video via satellite. VSAT networks have significant advantages to wireline and wireless networks, as VSATs can provide highly reliable, cost-effective, end-to-end communications regardless of the number of sites or their geographic locations.

We have a large installed customer base and have shipped more than 750,000 VSAT units to customers in over 85 countries on six continents since 1989. We have 16 sales and service offices worldwide and two call centers to support our customers. Our products are primarily sold to communication service providers and operators that use VSATs to serve enterprise, government and residential users. Also, in the U.S. and certain countries in Latin America, we provide services directly to end-users in various market segments.

We currently operate three complementary, vertically-integrated business units: Gilat Network Systems, or GNS, a provider of VSAT-based networks and associated professional services, including turnkey and management services, to telecom operators worldwide; Spacenet Inc. a provider of satellite network services to enterprises, small office/home office, or SOHOs, and residential customers in the U.S.; and Spacenet Rural Communications, or SRC, a provider of telephony, Internet and data services primarily for rural communities in emerging markets in Latin America under projects that are subsidized by government entities.

We were incorporated in Israel in 1987 and are subject to the laws of the State of Israel. Our corporate headquarters, executive offices and research and development, engineering and manufacturing facilities are located at Gilat House, 21 Yegia Kapayim Street, Kiryat Arye, Petah Tikva 49130, Israel. Our telephone number is (972) 3-925-2000.

The name Gilat® and the names Connexstar , SkyAbis , SkyEdge , Spacenet , and StarBand " appearing in this annual report on F trademarks of our company and its subsidiaries. See Item 4: Information on the Company. Other trademarks appearing in this annual report on Form 20-F are owned by their respective holders.

Except for the historical information contained in this annual report, the statements contained in this annual report are forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995 with respect to our business, financial condition and results of operations. Actual results could differ materially from those anticipated in these forward-looking statements as a result of various factors, including all the risks discussed in Item 3: Key Information Risk Factors and elsewhere in this annual report.

We urge you to consider that statements which use the terms believe, do not believe, expect, plan, intend, estimate, anticipate and expressions are intended to identify forward-looking statements. These statements reflect our current views with respect to future events and are based on assumptions and are subject to risks and uncertainties. Except as required by applicable law, including the securities laws of the U.S., we do not intend to update or revise any forward-looking statements, whether as a result of new information, future events or otherwise.

Our consolidated financial statements appearing in this annual report are prepared in U.S. dollars and in accordance with U.S. generally accepted accounting principles, or U.S. GAAP. All references in this annual report to dollars or $ are to U.S. dollars and all references in this annual report to NIS are to New Israeli Shekels. The representative exchange rate between the NIS and the dollar as published by the Bank of Israel on April 6, 2009 was NIS 4.125 per $1.00.

As used in this annual report, the terms we , us , Gilat and our mean Gilat Satellite Networks Ltd. and its subsidiaries, unless otherwise indicated.

Statements made in this annual report concerning the contents of any contract, agreement or other document are summaries of such contracts, agreements or documents and are not complete descriptions of all of their terms. If we filed any of these documents as an exhibit to this annual report or to any registration statement or annual report that we previously filed, you may read the document itself for a complete description.

- iii -

TABLE OF CONTENTS

		Page
Part I		
Item 1	Identity of Directors, Senior Management and Advisers	1
Item 2	Offer Statistics and Expected Timetable	1
Item 3	Key Information	1
Item 4	Information on the Company	17
Item 4A	Unresolved Staff Comments	31
Item 5	Operating and Financial Review and Prospects	31
Item 6	Directors and Senior Management	49
Item 7	Major Shareholders and Related Party Transactions	59
Item 8	Financial Information	61
Item 9	The Offer and Listing	64
Item 10	Additional Information	65
Item 11	Quantitative and Qualitative Disclosures about Market Risk	85
Item 12	Description of Securities Other than Equity Securities	85
Part II		
Item 13	Defaults, Dividends, Arrearages and Delinquencies	85
Item 14	Material Modifications to the Rights of Security Holders and Use of Proceeds	86
Item 15	Controls and Procedures	86
Item 16	[Reserved]	87
Item 16A	Audit Committee Financial Expert	87
Item 16B	Code of Ethics	87
Item 16C	Principal Accounting Fees and Services	87
Item 16D	Exemptions from the Listing Standards for Audit Committees	88
Item 16E	Purchase of Equity Securities by the Issuer and Affiliated Purchasers	88
Item 16F	Changes in Registrant's Certifying Accountant	88
Item 16G	Corporate Governance	88
Part III		
Item 17	Financial Statements	88
Item 18	Financial Statements	89
Item 19	Exhibits	89

- iv -

PART I

ITEM 1: IDENTITY OF DIRECTORS, SENIOR MANAGEMENT AND ADVISORS

Not Applicable.

ITEM 2: OFFER STATISTICS AND EXPECTED TIMETABLE

Not Applicable.

ITEM 3: KEY INFORMATION

A. Selected Consolidated Financial Data

The selected consolidated statement of operations data set forth below for the years ended December 31, 2008, 2007 and 2006, and the selected consolidated balance sheet data as of December 31, 2008 and 2007 are derived from our audited consolidated financial statements that are included elsewhere in this Report. These financial statements have been prepared in accordance with U.S. generally accepted accounting principles or U.S. GAAP. The selected consolidated statement of operations data set forth below for the years ended December 31, 2005 and 2004 and the selected consolidated balance sheet data as of December 31, 2006, 2005 and 2004 are derived from our audited consolidated financial statements that are not included in this Annual Report filed on Form 20F.

The selected consolidated financial data set forth below should be read in conjunction with Item 5: Operating and Financial Review and Prospects and the Consolidated Financial Statements and Notes thereto included in Item 18 in this annual report on Form 20-F for the year ended December 31, 2008.

1

	Year ended December 31.				
	2008	2007	2006	2005	2004
	U.S. Dollars in thousands				
Statement of Operations Data:					
Revenues:					
Products	$ 150,351	$ 156,798	$ 126,093	$ 88,705	$ 100,122
Services	117,175	125,821	122,617	120,690	141,376
	267,526	282,619	248,710	209,395	241,498
Cost of revenues:					
Products	80,424	82,822	66,363	42,896	50,703
Services	101,150	97,952	91,982	90,323	113,692
	181,574	180,774	158,345	133,219	164,395
Gross profit	85,952	101,845	90,365	76,176	77,103
Operating expenses:					
Research and development expenses, net	16,942	15,030	13,642	13,994	13,879
Selling and marketing expenses	35,783	38,374	36,475	31,329	33,282
General and administrative expenses	29,819	31,052	26,800	29,465	36,364
Impairment of long lived assets and other charges	5,020	12,218	-	-	2,161

	Year ended December 31.				
Operating income (loss)	(1,612)	5,171	13,448	1,388	(8,583)
Financial income (expenses), net.	1,300	5,998	(742)	(2,677)	(266)
Expenses related to aborted merger transaction	(2,350)		-	-	-
Other income (expense)	2,983	(116)	138	299	(274)
Income (loss) before taxes on income	321	11,053	12,844	(990)	(9,123)
Taxes on income	1,445	963	2,357	3,126	4,429
Income (loss) after taxes on income	(1,124)	10,090	10,487	(4,116)	(13,552)
Equity in earnings (losses) of affiliated companies		-	-	400	1,242
Minority interest in losses of a subsidiary		-	-	-	164
Income (loss) before cumulative effect of a change in an accounting principle	(1,124)	10,090	10,487	(3,716)	(12,146)
Gain (loss) from cumulative effect of a change in an accounting principle		-	-	-	611
Net income (loss)	(1,124)	$ 10,090	$ 10,487	$ (3,716)	$ (11,535)
Earnings (loss) per share before cumulative effect of a change in an accounting principle					
Basic	(0.03)	$ 0.26	$ 0.41	$ (0.17)	$ (0.55)
Diluted	(0.03)	$ 0.24	$ 0.38	$ (0.17)	$ (0.55)
Basic and diluted net earnings (loss) per share from cumulative effect of a change in an accounting principle		-	-	-	$ 0.03
Net earnings (loss) per share:					
Basic	(0.03)	$ 0.26	$ 0.41	$ (0.17)	$ (0.52)
Diluted	(0.03)	$ 0.24	$ 0.38	$ (0.17)	$ (0.52)
Weighted average number of shares used in computing net earnings (loss) per share:					
Basic	39,901	39,141	25,799	22,440	22,242
Diluted	39,901	41,576	27,520	22,440	22,242

	As of December 31,				
	2008	2007	2006	2005	2004
	U.S. dollars in thousands				

	As of December 31,				
Balance Sheet Data:					
Working capital	$ 152,806	$ 151,367	$ 120,634	$ 70,207	$ 67,750
Total assets	410,639	430,102	440,214	372,977	391,094
Short-term bank credit and current maturities of long-term debt	10,846	11,177	7,737	15,884	13,028
Convertible subordinated notes	16,315	16,315	16,333	16,333	16,171
Other long-term liabilities	45,414	61,130	74,253	156,490	179,453
Shareholders' equity	$ 230,224	$ 227,810	$ 212,059	$ 85,498	$ 81,421

B Capitalization and Indebtedness

Not applicable.

C. Reasons for the Offer and Use of Proceeds

Not applicable.

D. Risk Factors

Investing in our ordinary shares involves a high degree of risk and uncertainty. You should carefully consider the risks and uncertainties described below before investing in our ordinary shares. If any of the following risks actually occurs, our business, prospects, financial condition and results of operations could be harmed. In that case, the value of our ordinary shares could decline, and you could lose all or part of your investment.

Risks Relating to Our Business

We have incurred major losses in past years and may not sustain profitable operations in the future.

We had a net loss of approximately $1.1 million in 2008, compared to a net income of approximately $ 10.1 million in 2007 and approximately $ 10.5 million in 2006 and we have an accumulated deficit of $635 million. We cannot assure you that we can operate profitably in the future. If we do not regain profitability, the viability of our company will be in question and our share price could further decline.

If commercial satellite communications markets fail to grow, our business could be materially harmed.

A number of the commercial markets for our products and services in the satellite communications area, including our broadband products, have emerged in recent years. Because these markets are relatively new, it is difficult to predict the rate at which these markets will grow, if at all. If the markets for commercial satellite communications products fail to grow our business could be materially harmed. Conversely, growth in these markets could results in satellite capacity limitations which in turn could materially harm our business and impair the value of our shares. Specifically, we derive virtually all of our revenues from sales of VSAT communications networks and provision of services related to these networks. A significant decline in this market or the replacement of VSAT technology by an alternative technology could materially harm our business and impair the value of our shares.

Trends and factors affecting the telecommunications industry are beyond our control and may result in reduced demand and pricing pressure on our products.

We operate in the telecommunication industry and are influenced by trends of the telecommunications industry, which are beyond our control and may affect our operations. These trends include:

adverse changes in the public and private equity and debt markets and our ability, as well as the ability of our customers and suppliers, to obtain financing or to fund working capital and capital expenditures;

adverse changes in the credit ratings of our customers and suppliers;

adverse changes in the market conditions in our industry and the specific markets for our products;

access to, and the actual size and timing of, capital expenditures by our customers;

inventory practices, including the timing of product and service deployment, of our customers;

the amount of network capacity and the network capacity utilization rates of our customers, and the amount of sharing and/or acquisition of new and/or existing network capacity by our customers;

the overall trend toward industry consolidation and rationalization among our customers, competitors, and suppliers;

increased price reductions by our direct competitors and by competing technologies including, for example, the introduction of Ka-band satellite systems by our direct competitors which could significantly drive down market prices or limit the availability of satellite capacity for use with our VSAT systems;

conditions in the broader market for communications products, including data networking products and computerized information access equipment and services;

governmental regulation or intervention affecting communications or data networking;

monetary stability in the countries where we operate; and

the effects of war and acts of terrorism, such as disruptions in general global economic activity, changes in logistics and security arrangements, and reduced customer demand for our products and services.

These trends and factors may reduce the demand for our products and services or require us to increase our research and development expenses and may harm our financial results.

Continuing unfavorable global economic conditions could have a material adverse effect on our business, operating results and financial condition

The recent crisis in the financial and credit markets has led to a global economic slowdown, with economies worldwide showing significant signs of weakness. If the economies in any part of the world continue to be weak or weaken further, our customers may reduce or postpone their spending significantly. This could result in reductions in sales of our products or services, longer sales cycles, slower adoption of new technologies and increased price competition. In addition, weakness in the end-user market could negatively affect the cash flow of our customers who could, in turn, delay paying their obligations to us or ask us for vendor financing. This could increase our credit risk exposure and cause delays in our recognition of revenues on future sales to these customers. Specific economic trends, such as declines in the demand for telecommunications products and services, the tightening of credit markets, or weakness in corporate spending, could have a direct impact on our business. Any of these events would likely harm our business, operating results and financial condition. If global economic and market conditions do not improve, or continue to deteriorate, it may have a material adverse effect on our business, operating results and financial condition.

Because we compete for large-scale contracts in competitive bidding processes, losing a small number of bids could have a significant adverse impact on our operating results.

A significant portion of our revenues is derived from being selected as the supplier of networks based on VSATs, under large-scale contracts that we are awarded from time to time in a competitive bidding process. These large-scale contracts sometimes involve the installation

of thousands of VSATs. The number of major bids for these large-scale contracts for VSAT-based networks in any given year is limited and the competition is intense. Losing or defaulting on a relatively small number of bids each year could have a significant adverse impact on our operating results.

Many of our large-scale contracts are with governments or large enterprises in Latin America and other parts of the world, so that any instability in the exchange rates or in the political or economic situation or any unexpected unilateral termination or suspension of payments could have a significant adverse impact on our business.

In recent years, a significant portion of our revenues has been derived from large-scale contracts with foreign governments and agencies, including those in Peru, Russia, Colombia and Mexico. Agreements with the governments in these countries typically include unilateral early termination clauses and other risks such as the imposition of new government regulations and taxation that could pose additional financial burdens on us. In addition, the foreign exchange risks in these countries are often significant due to possible fluctuations in local currencies relative to the U.S. dollar. We do not have a policy of hedging specific contracts. In some cases we hedge the risks involved in our general operations in Israel and in our subsidiaries abroad. Any termination of business in any of the aforementioned countries or any instability in the exchange rates could have a significant adverse impact on our business.

In November 2002, we were awarded two large projects by the Colombian government, including the installation and operation of approximately 550 telecenters to provide Internet connectivity and telephony services in cities and towns throughout Colombia and a second network of approximately 3,300 sites with public rural satellite telephony. The original total value of the contracts was approximately $72 million and the remaining value of the contracts, which are being held in restricted cash, is approximately $24.0 million as of December 31, 2008. As of December 31, 2008, we signed new agreements for the provision of services under these contracts which include the upgrade of technology, primarily in existing sites, requiring additional capital expenditure by us. While we expect that most of the $24 million held in restricted cash will be released during 2009, with the remaining amount to be released in 2010, we cannot make any assurances that we will be able to comply with the newly negotiated indicators and agreement terms. In addition, any early unilateral termination by the Colombian government could have a significant adverse impact on our operating results. Moreover, in the event that we do not generate new substantial business in Colombia during 2009 or 2010, our operations in Colombia will most likely generate losses in 2010.

If we are unable to develop, introduce and market new innovative products, applications and services on a cost-effective and timely basis, our business could be adversely affected.

The network communications market, to which our products and services are targeted, is characterized by rapid technological changes, new product introductions and evolving industry standards. If we fail to stay abreast of significant technological changes, our existing products and technology could be rendered obsolete. Historically, we have enhanced the applications of our existing products to meet the technological changes and industry standards. Our success is dependent upon our ability to continue to develop new innovative products, applications and services and meet developing market needs.

To remain competitive in the network communications market, we must continue to be able to anticipate changes in technology, market demands and industry standards and to develop and introduce new products, applications and services, as well as enhancements to our existing products, applications and services. If we are unable to respond to technological advances on a cost-effective and timely basis, or if our new products or applications are not accepted by the market, our business, financial condition and operating results could be adversely affected.

A decrease in the selling prices of our products and services could materially harm our business.

The average selling prices of wireless communications products historically decline over product life cycles. In particular, we expect the average selling prices of our products to decline as a result of competitive pricing pressures and customers who negotiate discounts based on large unit volumes. In some markets, such as in the US, our competitors have launched Ka-band satellites and another has announced plans to launch a Ka-band satellite. These actions may affect our competitiveness due to the relative lower cost of Ka-band space segment per user. We also expect that competition in this industry will continue to increase. To offset these price decreases, we intend to rely primarily on obtaining yield improvements and corresponding cost reductions in the manufacturing process of existing products, on the introduction of new products with advanced features and on offering turnkey end-to-end solutions to communications operators that are higher up in the value chain. However, we cannot assure you that we will be able to obtain any yield improvements or cost reductions, introduce any new products in the future or reach the higher value chain to which we strive to sell. To the extent that we do not meet any or all of these goals, it could materially harm our business and impair the value of our shares.

If we lose existing contracts and orders for our products are not renewed, our ability to generate revenues will be harmed.

A significant part of our business in 2008 was generated from recurring customers, and, as a result, the termination or non-renewal of our contracts could have a material adverse effect on our business, financial condition and operating results. Some of our existing contracts could be terminated due to any of the following reasons, among others:

dissatisfaction of our customers with our products and/or the services we provide or our inability to provide or install additional products or requested new applications on a timely basis;

customers' default on payments due;

our failure to comply with financial covenants in our contracts;

the cancellation of the underlying project by the government-sponsoring body; or

the loss of existing contracts or a decrease in the number of renewals of orders or the number of new large orders.

If we are not able to gain new customers and retain our present customer base, our revenues will decline significantly. In addition, if Spacenet has a higher than anticipated subscriber churn, or if Spacenet Rural does not win new government related contracts, as was the case in 2008, this could materially adversely affect our financial position.

We are dependent upon a limited number of suppliers for key components to build our hubs and VSATs, and may be significantly harmed if we are unable to obtain the hardware necessary for our hubs and VSATs on favorable terms or on a timely basis.

Several of the components required to build our VSATs and hubs are manufactured by a limited number of suppliers. We have not experienced any difficulties with our suppliers with respect to availability of components. However, we cannot assure you of the continuous availability of key components or our ability to forecast our component requirements sufficiently in advance. Our research and development and operations groups are continuously working with our suppliers and subcontractors to obtain components for our products on favorable terms in order to reduce the overall price of our products. If we are unable to obtain the necessary volume of components at sufficiently favorable terms or prices, we may be unable to produce our products at favorable terms or prices. As a result, sales of our products may be lower than expected, which could have a material adverse effect on our business, financial condition and operating results. Our suppliers are not always able to meet our requested lead times. If we are unable to satisfy customers needs, we could lose their business.

In 2007 we entered into an outsourcing manufacturing agreement with a single source manufacturer for almost all of our indoor units. This agreement exposes us to certain risks related to our dependence on a single manufacturer which could include failure in meeting time tables and quantities, or material price increases which may affect our ability to provide competitive prices. We estimate that the replacement of the outsourcing manufacturer would, if necessary, take a period of between six to nine months.

We operate in a highly competitive network communications industry. We may be unsuccessful in competing effectively against competitors who have substantially greater financial resources.

We operate in a highly competitive industry of network communications, both in the sales of our products and our services. As a result of the rapid technological changes that characterize our industry, we face intense worldwide competition to capitalize on new opportunities, to introduce new products and to obtain proprietary and standard technologies that are perceived by the market as being superior to those of our competitors. Some of our competitors have greater financial resources, providing them with greater research and development and marketing capabilities. Our competitors may also be more experienced in obtaining regulatory approvals for their products and services and in marketing them. Our relative position in the network communications industry may place us at a disadvantage in responding to our competitors pricing strategies, technological advances and other initiatives. Our principal competitors in the supply of VSAT networks are Hughes Network Systems, LLC, or HNS, ViaSat Inc., and iDirect Technologies. Most of our competitors have developed or adopted different technology standards for their VSAT products.

In addition, the launch of the SpaceWAY3 satellite by HNS, which enables HNS to offer a vertically integrated solution to its customers, as well as the announcement concerning ViaSat Inc. s intention to launch its own satellite (ViaSat-1), may change the competitive environment in

which we operate and could have an adverse effect on our business.

In the U.S. market, where we operate as a service provider via Spacenet, the enterprise wide area network, or WAN, market is extremely competitive, with a number of established VSAT and terrestrial providers competing for nearly all contracts. The U.S. enterprise VSAT market is primarily served by HNS and Spacenet. In addition, more recently, Spacenet s primary competitors in the enterprise WAN market are large terrestrial carriers such as AT&T, Verizon and Qwest.

In Peru and Colombia, where we primarily operate public rural telecom services we typically encounter competition on government subsidized bids from various service providers, system integrators and consortiums. Some of these competitors offer solutions based on VSAT technology and some on alternate technologies (typically cellular, wireless local loop or WiMAX). As operators that offer terrestrial or cellular networks expand their reach to certain SRC regions, they compete with our VSAT solutions. In addition, as competing technologies such as cellular telephones become available in areas where not previously available in rural communities of Peru and Colombia, our business can be adversely affected.

Our actions to protect our proprietary VSAT technology may be insufficient to prevent others from developing products similar to our products.

Our business is based mainly on our proprietary VSAT technology and related products and services. We establish and protect proprietary rights and technology used in our products by the use of patents, trade secrets, copyrights and trademarks. We also utilize non-disclosure and intellectual property assignment agreements. Because of the rapid technological changes and innovation that characterize the network communications industry, our success will depend in large part on our ability to protect and defend our intellectual property rights. Our actions to protect our proprietary rights in our VSAT technology and related products may be insufficient to prevent others from developing products similar to our products. In addition, the laws of many foreign countries do not protect our intellectual property rights to the same extent as the laws of the U.S. If we are unable to protect our intellectual property, our ability to operate our business and generate expected revenues may be harmed.

We depend on a single facility in Israel and are susceptible to any event that could adversely affect its condition.

Most of our laboratory capacity, our principal offices and principal research and development facilities are concentrated in a single location in Israel. Fire, natural disaster or any other cause of material disruption in our operation in this location could have a material adverse effect on our business, financial condition and operating results. As discussed above, to remain competitive in the network communications industry, we must respond quickly to technological developments. Damage to our facility in Israel could cause serious delays in the development of new products and services and, therefore, could adversely affect our business. In addition, the particular risks relating to our location in Israel are described below.

Our international sales expose us to changes in foreign regulations and tariffs, tax exposures, political instability and other risks inherent to international business, any of which could adversely affect our operations.

We sell and distribute our products and provide our services internationally, particularly in the U.S., Latin America, Asia, Africa and Europe. A component of our strategy is to continue to expand into new international markets. Our operations can be limited or disrupted by various factors known to affect international trade. These factors include the following:

- imposition of governmental controls, regulations and taxation which might include a government s decision to raise import tariffs or license fees in countries in which we do business;

- government regulations that may prevent us from choosing our business partners or restrict our activities. For example, a particular Latin American country may decide that high-speed data networks used to provide access to the Internet should be made available generally to Internet service providers and may require us to provide our wholesale service to any Internet service provider that request it, including entities that compete with us. If we become subject to any additional obligations such as these, we would be forced to comply with potentially costly requirements and limitations on our business activities, which could result in a substantial reduction in our revenue;

- tax exposures in various jurisdictions relating to our activities throughout the world;

- political and/or economic instability in countries in which we do or desire to do business. For example, economic instability in Brazil has led to volatility of the value of the Brazilian Reals. Such unexpected changes have had an adverse affect on the gross margin of our projects in Brazil. We also face similar risks from potential or current political and economic instability as well as volatility of foreign

currencies in countries such as Colombia, Russia, Kazakhstan, Angola, and India.

trade restrictions and changes in tariffs which could lead to an increase in costs associated with doing business in foreign countries;

difficulties in staffing and managing foreign operations that might mandate employing staff in the U.S. and Israel to manage foreign operations. This change could have an adverse effect on the profitability of certain projects;

longer payment cycles and difficulties in collecting accounts receivable;

seasonal reductions in business activities;

foreign exchange risks due to fluctuations in local currencies relative to the dollar; and

relevant zoning ordinances that may restrict the installation of satellite antennas and might also reduce market demand for our service. Additionally, authorities may increase regulation regarding the potential radiation hazard posed by transmitting earth station satellite antennas emissions of radio frequency energy that may negatively impact our business plan and revenues.

Any decline in commercial business in any country may have an adverse effect on our business as these trends often lead to a decline in technology purchases or upgrades by private companies. We expect that in difficult economic periods, such as the current recession, countries in which we do business will find it more difficult to raise financing from investors for the further development of the telecommunications industry, and private companies will find it more difficult to finance the purchase or upgrade of our technology. Any such changes could adversely affect our business in these and other countries.

We may face difficulties in obtaining regulatory approvals for our telecommunication services, which could adversely affect our operations.

Our telecommunication services require licenses and approvals by the Federal Communications Commission, or FCC, in the U.S., and by regulatory bodies in other countries. In the U.S., the operation of satellite earth station facilities and VSAT systems such as ours are prohibited except under licenses issued by the FCC. We must also obtain approval of the regulatory authority in each country in which we propose to provide network services or operate VSATs. The approval process in Latin America and elsewhere can often take a substantial amount of time and require substantial resources.

In addition, any approvals that are granted may be subject to conditions that may restrict our activities or otherwise adversely affect our operations. Also, after obtaining the required approvals, the regulating agencies may, at any time, impose additional requirements on our operations. We cannot assure you that we will be able to comply with any new requirements or conditions imposed by such regulating agencies on a timely or economically efficient basis.

Our lengthy sales cycles could harm our results of operations if forecasted sales are delayed or do not occur.

The length of time between the date of initial contact with a potential customer or sponsor and the execution of a contract with the potential customer or sponsor may be lengthy and vary significantly depending on the nature of the arrangement. During any given sales cycle, we may expend substantial funds and management resources and not obtain significant revenue, resulting in a negative impact on our operating results.

In the past year, we have seen longer sales cycles, primarily in the emerging markets. If this trend continues and is exacerbated, it could have an adverse effect on our ability to achieve profitability.

Our operating results may vary significantly from quarter to quarter and these quarterly variations in operating results, as well as other factors, may contribute to the volatility of the market price of our shares.

Our operating results have and may continue to vary significantly from quarter to quarter. The causes of fluctuations include, among other things:

the timing, size and composition of orders from customers;

the timing of introducing new products and product enhancements by us and the level of their market acceptance;

the mix of products and services we offer; and

the changes in the competitive environment in which we operate.

The quarterly variation of our operating results, may, in turn, create volatility in the market price for our shares. Other factors that may contribute to wide fluctuations in our market price, many of which are beyond our control, include, but are not limited to:

economic instability;

announcements of technological innovations;

customer orders or new products or contracts;

competitors' positions in the market;

changes in financial estimates by securities analysts;

conditions and trends in the VSAT and other technology industries;

our earnings releases and the earnings releases of our competitors; and

the general state of the securities markets (with particular emphasis on the technology and Israeli sectors thereof).

In addition to the volatility of the market price of our shares, the stock market in general and the market for technology companies in particular have been highly volatile and at times thinly traded. Investors may not be able to resell their shares during and following periods of volatility.

We may at times be subject to claims by third parties alleging that we are infringing on their intellectual property rights. We may be required to commence litigation to protect our intellectual property rights. Any intellectual property litigation may continue for an extended period and may materially adversely affect our business, financial condition and operating results.

There are numerous patents, both pending and issued, in the network communications industry. We may unknowingly infringe on a patent. We may from time to time be notified of claims that we are infringing on the patents, copyrights or other intellectual property rights owned by third parties. While we do not believe that we have in the past or are at present infringed on any intellectual property rights of third parties, we cannot assure you that we will not be subject to such claims.

In addition, we may be required to commence litigation to protect our intellectual property rights and trade secrets, to determine the validity and scope of the proprietary rights of others or to defend against third-party claims of invalidity. An adverse result in any litigation could force us to pay substantial damages, stop designing or manufacturing, using and selling the infringing products, spend significant resources to develop non-infringing technology, discontinue using certain processes or obtain licenses to use the infringing technology. In addition, we may not be able to develop non-infringing technology, and we may not be able to find appropriate licenses on reasonably satisfactory terms. Any such litigation could result in substantial costs and diversion of resources and could have a material adverse effect on our business, financial condition and operating results.

Potential product liability claims relating to our products could have a material adverse effect on our business.

We may be subject to product liability claims relating to the products we sell. Potential product liability claims could include those for exposure to electromagnetic radiation from the antennas we provide. Our agreements with our business customers generally contain provisions designed to limit our exposure to potential product liability claims. We also maintain a product liability insurance policy. However, our

insurance may not cover all relevant claims or may not provide sufficient coverage. To date, we have not experienced any material product liability claim. Our business, financial condition and operating results could be materially adversely affected if costs resulting from future claims are not covered by our insurance or exceed our coverage.

Our insurance coverage may not be sufficient for every aspect or risk related to our business.

Our business includes risks, only some of which are covered by our insurance. For example, in many of our satellite capacity agreements, we do not have a back up for satellite capacity, and we do not have indemnification or insurance in the event that our supplier s satellite malfunctions or is lost. In addition, we are not covered by our insurance for acts of fraud or theft. Our business, financial condition and operating results could be materially adversely affected if we incur significant costs resulting from these exposures.

We may engage in acquisitions that could harm our business, results of operations and financial condition, and dilute our shareholders equity.

We have a corporate business development team whose goal is to pursue new business opportunities. This team pursues growth opportunities through internal development and through the acquisition of complementary businesses, products and technologies. We are unable to predict whether or when any prospective acquisition will be completed. The process of integrating an acquired business may be prolonged due to unforeseen difficulties and may require a disproportionate amount of our resources and management s attention. We cannot assure you that we will be able to successfully identify suitable acquisition candidates, complete acquisitions, integrate acquired businesses into our operations, or expand into new markets. Further, once integrated, acquisitions may not achieve comparable levels of revenues, profitability or productivity as our existing business or otherwise perform as expected. The occurrence of any of these events could harm our business, financial condition or results of operations. Future acquisitions may require substantial capital resources, which may not be available to us or may require us to seek additional debt or equity financing. Future acquisitions by us could result in the following, any of which could seriously harm our results of operations or the price of our shares:

- issuance of equity securities that would dilute our current shareholders' percentages of ownership;
- large one-time write-offs;
- the incurrence of debt and contingent liabilities;
- difficulties in the assimilation and integration of operations, personnel, technologies, products and information systems of the acquired companies;
- diversion of management's attention from other business concerns;
- contractual disputes;
- risks of entering geographic and business markets in which we have no or only limited prior experience; and
- potential loss of key employees of acquired organizations.

Our failure to manage growth effectively could impair our business, financial condition and results of operations.

Risks Related to Ownership of Our Ordinary Shares

Our share price has been highly volatile and may continue to be volatile and decline.

The trading price of our shares has fluctuated widely in the past and may continue to do so in the future as a result of a number of factors, many of which are outside our control. In addition, the stock market has experienced extreme price and volume fluctuations that have affected the market prices of many technology companies, particularly telecommunication and Internet-related companies, and that have often been unrelated or disproportionate to the operating performance of these companies. These broad market fluctuations could adversely affect the market price of our shares. In the past, following periods of volatility in the market price of a particular company s securities, securities class action litigation has often been brought against that company. Securities class action litigation could result in substantial costs and a diversion of

our management s attention and resources.

If U.S. tax authorities were to treat us as a "passive foreign investment company", that could have an adverse consequences on U.S. holders.

Holders of our ordinary shares who are United States residents face income tax risks. There is a risk that we will be treated as a passive foreign investment company. Our treatment as a passive foreign investment company could result in a reduction in the after-tax return to the holders of our ordinary shares and would likely cause a reduction in the value of such shares. A foreign corporation will be treated as a passive foreign investment company for U.S. federal income tax purposes if either (1) at least 75% of its gross income for any taxable year consists of certain types of passive income, or (2) at least 50% of the average value of the corporation s gross assets produce, or are held for the production of, such types of passive income. For purposes of these tests, passive income includes dividends, interest, gains from the sale or exchange of investment property and rents and royalties other than rents and royalties that are received from unrelated parties in connection with the active conduct of trade or business. For purposes of these tests, income derived from the performance of services does not constitute passive income. Those holders of shares in a passive foreign investment company who are citizens or residents of the United States or domestic entities would alternatively be subject to a special adverse U.S. federal income tax regime with respect to the income derived by the passive foreign investment company, the distributions they receive from the passive foreign investment company and the gain, if any, they derive from the sale or other disposition of their shares in the passive foreign investment company. In particular, any dividends paid by us would not be treated as qualified dividend income eligible for preferential tax rates in the hands of non-corporate U.S. shareholders.

11

The concentration of our ordinary share ownership may limit our shareholders ability to influence corporate matters.

As of March 31, 2009, York Capital Management, or York, and entities affiliated with them beneficially own or vote approximately 20% of our outstanding ordinary shares. As a result, York may have a substantial influence over all matters that require approval by our shareholders, including the election of directors and approval of significant corporate transactions. As a result, corporate actions might be taken even if other shareholders oppose them. This concentration of ownership might also have the effect of delaying or preventing a change of control of our company that other shareholders may view as beneficial.

Future sales of our ordinary shares and the future exercise of options may cause the market price of our ordinary shares to decline and may result in substantial dilution.

We cannot predict what effect, if any, future sales of our ordinary shares by York and our other 5% shareholders, or the availability of our ordinary shares for future sale, including shares issuable upon the exercise of our options, will have on the market price of our ordinary shares. Sales of substantial amounts of our ordinary shares in the public market by our 5% shareholders, or the perception that such sales could occur, could adversely affect the market price of our ordinary shares and may make it more difficult for you to sell your ordinary shares at a time and price you deem appropriate.

We have never paid cash dividends and have no intention to pay dividends in the foreseeable future.

We have never paid cash dividends on our shares and do not anticipate paying any cash dividends in the foreseeable future. We intend to continue retaining earnings for use in our business, in particular to fund our research and development, which are important to capitalize on technological changes and develop new products and applications. In addition, the terms of some of our financing arrangements restrict us from paying dividends to our shareholders.

Our ordinary shares are traded on more than one market and this may result in price variations.

Our ordinary shares are traded on the NASDAQ Global Market and on the Tel Aviv Stock Exchange. Trading in our ordinary shares on these markets is made in different currencies (U.S. dollars on the NASDAQ Global Market, and new Israeli Shekels, or NIS, on the Tel Aviv Stock Exchange), and at different times (resulting from different time zones, different trading days and different public holidays in the U.S. and Israel). Consequently, the trading prices of our ordinary shares on these two markets often differ. Any decrease in the trading price of our ordinary shares on one of these markets could cause a decrease in the trading price of our ordinary shares on the other market.

12

A request for a class action lawsuit has been filed against us and the results, if admitted as a formal class action in the District Court of Jerusalem, could have an adverse effect on our business.

In October 2008, a lawsuit and a motion for its approval as a class action proceeding was filed in the District Court of Jerusalem by eight individuals and Israeli companies against us, claiming damages based on the amounts the shareholders would have been paid had the aborted merger agreement with the consortium of investors closed.

We have filed a response and request to dismiss the motion which is pending. We believe that the allegations against us and certain of our current and former officers and directors are without merit and intend to contest them vigorously. However, these legal proceedings are in the preliminary stages and we cannot predict their outcome. The litigation process is inherently uncertain. If we are not successful in defending these legal proceedings, we could incur substantial monetary judgments or penalties in excess of available insurance coverage or result in damage to our reputation, and whether or not we are successful, the proceedings could result in substantial costs and may occupy a significant amount of time and attention of our senior management.

Risks Related To Regulatory Matters

We have historically relied, and in the future intend to rely, upon tax benefits from the State of Israel to reduce our taxable income. The termination or reduction of these tax benefits would significantly increase our costs and could have a material adverse effect on our financial condition and results of operations.

Under the Israeli Law for Encouragement of Capital Investments, 1959 (Investment Law), portions of our Israeli facility qualify as Approved Enterprises. As a result, we have been eligible for tax benefits for the first several years in which we generated taxable income from such Approved Enterprise. Our historical operating results reflect substantial tax benefits, including tax exemptions and decreased tax rates up to December 31, 2000. In 2001, 2002 and 2003, we had substantial losses for tax purposes and a decrease in revenues and therefore could not realize any tax benefits since then due to current and/or carry forward losses. On April 1, 2005, an amendment to the Investment Law, or the Amendment, came into effect, and has significantly changed the provisions of the Investment Law and the criteria for new investments qualified to receive tax benefits. The Amendment enacted major changes in the manner in which tax benefits are awarded under the Investment Law so that companies no longer require approval of the Investment Center of the Ministry of Industry, Commerce and Labor of the State of Israel, or the Investment Center, in order to qualify for tax benefits. The Amendment will be applied to new approved enterprises, and there is no assurance that we will, in the future, be eligible to receive additional tax benefits under this law. Our financial condition and results of operations could suffer if the Israeli government terminated or reduced the current tax benefits available to us.

In order to be eligible for these tax benefits under the Amendment, we must comply with two material conditions. We must invest a specified amount in property and equipment in Israel, and at least 25% of each new Approved Enterprise income should be derived from export. We believe we have complied with these conditions, but we have not received confirmation of our compliance from the Israeli government. If we fail in the future to comply in whole or in part with these conditions, we may be required to pay additional taxes and would likely be denied these tax benefits in the future, which could harm our financial condition and results of operations. For additional information concerning Israeli taxation, please see Israeli Taxation.

The transfer and use of some of our technology and its production is limited because of the research and development grants we received from the Israeli government to develop such technology.

Our research and development efforts associated with the development of certain of our legacy products have been partially financed through grants from the Office of the Chief Scientist of the Israeli Ministry of Industry, Trade and Labor. We may be subject to certain restrictions under the terms of the Chief Scientist grants. Specifically, any product incorporating technology developed with the funding provided by these grants may not be manufactured, nor may the technology which is embodied in our products be transferred outside of Israel without appropriate governmental approvals. These restrictions do not apply to the sale or export from Israel of our products developed with this technology.

Your rights and responsibilities as a shareholder are governed by Israeli law and differ in some respects from those under Delaware law.

Because we are an Israeli company, the rights and responsibilities of our shareholders are governed by our articles of association and by Israeli law. These rights and responsibilities differ in some respects from the rights and responsibilities of shareholders in a Delaware corporation. In particular, a shareholder of an Israeli company has a duty to act in good faith towards the company and other shareholders and to refrain from abusing his, her or its power in the company, including, among other things, in voting at the general meeting of shareholders on

certain matters. Israeli law provides that these duties are applicable to shareholder votes on, among other things, amendments to a company s articles of association, increases in a company s authorized share capital, mergers and interested party transactions requiring shareholder approval. In addition, a shareholder who knows that it possesses the power to determine the outcome of a shareholders vote or to appoint or prevent the appointment of a director or executive officer in the company has a duty of fairness towards the company. However, Israeli law does not define the substance of this duty of fairness. Because Israeli corporate law has undergone extensive revisions in recent years, there is little case law available to assist in understanding the implications of these provisions that govern shareholder behavior.

As a foreign private issuer whose shares are listed on the NASDAQ Global Market, we may follow certain home country corporate governance practices instead of certain NASDAQ requirements, which may not afford shareholders with the same protections that shareholders of domestic companies have.

As a foreign private issuer whose shares are listed on the NASDAQ Global Market, we are permitted to follow certain home country corporate governance practices instead of certain requirements of the NASDAQ Marketplace Rules. A foreign private issuer that elects to follow a home country practice instead of such requirements must submit to NASDAQ in advance a written statement from an independent counsel in such issuer s home country certifying that the issuer s practices are not prohibited by the home country s laws. In addition, a foreign private issuer must disclose in its annual reports filed with the Securities and Exchange Commission each such requirement that it does not follow and describe the home country practice followed by the issuer instead of any such requirement. As an Israeli company listed on the NASDAQ Global Market, we expect to follow home country practice with regard to, among other things, composition of the board of directors, director nomination procedure, compensation of officers, distribution of annual reports to shareholders and quorum at shareholders meetings. In addition, we expect to follow Israeli law instead of the NASDAQ Marketplace Rules that require that we obtain shareholder approval for certain dilutive events, such as for the establishment or amendment of certain equity-based compensation plans, an issuance that will result in a change of control of the company, certain transactions other than a public offering involving issuances of a 20% or more interest in the company and certain acquisitions of the stock or assets of another company.

We may fail to maintain effective internal controls in accordance with Section 404 of the Sarbanes-Oxley Act of 2002, which could have an adverse effect on our financial results and the market price of our ordinary shares.

The Sarbanes-Oxley Act of 2002 imposes certain duties on us and our executives and directors. Our efforts to comply with the requirements of Section 404, which started in connection with our 2006 Annual Report on Form 20-F, have resulted in increased general and administrative expense and a diversion of management time and attention, and we expect these efforts to require the continued commitment of resources. Section 404 of the Sarbanes-Oxley Act requires us to provide (i) management s annual review and evaluation of our internal control over financial reporting and (ii) a statement by management that its independent registered public accounting firm has issued an attestation report on our internal control over financial reporting, in connection with the filing of the Annual Report on Form 20-F for each fiscal year. The rules governing the standards that must be met for management to assess our internal control over financial reporting are complex and require significant documentation, testing and possible remediation to meet the detailed standards under the rules. During the course of its testing, our management may identify material weaknesses or significant deficiencies, which may not be remedied prior to the deadline imposed by the Sarbanes-Oxley Act. If we fail to maintain the adequacy of our internal controls, we may not be able to ensure that we can conclude on an ongoing basis that we have effective internal controls over financial reporting. Failure to maintain effective internal controls over financial reporting could result in investigation or sanctions by regulatory authorities, and could have a material adverse effect on our operating results, investor confidence in our reported financial information, and the market price of our ordinary shares.

Risks Related to Our Location in Israel

Political and economic conditions in Israel may limit our ability to produce and sell our products. This could have a material adverse effect on our operations and business.

We are incorporated under the laws of the State of Israel, where we also maintain our headquarters and most of our research and development and manufacturing facilities. Political, economic and security conditions in Israel directly influence us. Since the establishment of the State of Israel in 1948, Israel and its Arab neighbors have engaged in a number of armed conflicts. A state of hostility, varying in degree and intensity, has led to security and economic problems for Israel. Major hostilities between Israel and its neighbors may hinder Israel s international trade and lead to economic downturn. This, in turn, could have a material adverse effect on our operations and business.

There has been an increase in unrest and terrorist activity in Israel, which began in September 2000 and which has continued with varying levels of severity through 2008. The future effect of this deterioration and violence on the Israeli economy and our operations is unclear. The election of representatives of the Hamas movement to a majority of seats in the Palestinian Legislative Council in January 2006 resulted in an escalation in violence among Israel, the Palestinian Authority and other groups. In July 2006, extensive hostilities began along Israel s northern border with Lebanon and to a lesser extent in the Gaza Strip. In January 2009, Israel attacked Hamas strongholds in the Gaza strip, in reaction to rockets that were fired from Gaza and which landed in Israel. Ongoing violence between Israel and the Palestinians as well as tension between Israel and the neighboring Syria and Lebanon may have a material adverse effect on our business, financial condition and results of operations.

Furthermore, there are a number of countries, primarily in the Middle East, as well as Malaysia and Indonesia, that restrict business with Israel or Israeli companies, and we are precluded from marketing our products directly to these countries. Restrictive laws or policies directed towards Israel or Israeli businesses may have an adverse impact on our operations, our financial results or the expansion of our business.

Our results of operations may be negatively affected by the obligation of our personnel to perform military service.

Many of our employees in Israel are obligated to perform annual reserve duty in the Israeli Defense Forces and may be called for active duty under emergency circumstances at any time. If a military conflict or war arises, these individuals could be required to serve in the military for extended periods of time. Our operations could be disrupted by the absence for a significant period of one or more of our key employees or a significant number of other employees due to military service. Any disruption in our operations could adversely affect our business.

Because most of our revenues are generated in dollars or are linked to the dollar while a portion of our expenses are incurred in NIS, our results of operations would be adversely affected if inflation in Israel is not offset on a timely basis by a devaluation of the NIS against the dollar.

Most of our revenues are in dollars or are linked to the dollar, while a portion of our expenses, principally salaries and related personnel expenses, are in NIS. Therefore, our NIS related costs, as expressed in U.S. dollars, are influenced by the exchange rate between the U.S. dollar and the NIS. During 2008, the NIS appreciated against the U.S. dollar, which resulted in a significant increase in the U.S. dollar cost of our NIS expenses. We are also exposed to the risk that the rate of inflation in Israel will exceed the rate of devaluation of the NIS in relation to the dollar or that the timing of this devaluation lags behind inflation in Israel. This would have the effect of increasing the dollar cost of our operations. In the past, the NIS has devalued against foreign currencies, generally reflecting inflation rate differentials. We cannot predict any future trends in the rate of inflation in Israel or the rate of devaluation or appreciation of the NIS against the dollar. If the dollar cost of our operations in Israel increases, our dollar-measured results of operations will be adversely affected.

You may not be able to enforce civil liabilities in the U.S. against our officers and directors.

Most of our executive officers are non-residents of the U.S. A significant portion of our assets and the personal assets of most of our directors and executive officers are located outside the U.S. Therefore, it may be difficult to effect service of process upon any of these persons within the U.S. In addition, a judgment obtained in the U.S. against us, and most of our directors and executive officers, including but not limited to judgments based on the civil liability provisions of the U.S. federal securities laws, may not be collectible in the U.S.

Generally, it may also be difficult to bring an original action in an Israeli court to enforce judgments based upon the U.S. federal securities laws against us and most of our directors and executive officers. Subject to particular time limitations, executory judgments of a U.S. court for liquidated damages in civil matters may be enforced by an Israeli court, provided that:

- the judgment was obtained after due process before a court of competent jurisdiction, that recognizes and enforces similar judgments of Israeli courts, and according to the rules of private international law currently prevailing in Israel;
- adequate service of process was effected and the defendant had a reasonable opportunity to be heard;
- the judgment and its enforcement are not contrary to the law, public policy, security or sovereignty of the State of Israel;
- the judgment was not obtained by fraud and does not conflict with any other valid judgment in the same matter between the same parties;
- the judgment is no longer appealable; and
- an action between the same parties in the same matter is not pending in any Israeli court at the time the lawsuit is instituted in the foreign court.

If a foreign judgment is enforced by an Israeli court, it will be payable in Israeli currency.

Additionally, it may be difficult for an investor or any other person or entity, to assert U.S. securities law claims in original actions instituted in Israel. Israeli courts may refuse to hear a claim based on a violation of U.S. securities laws on the ground that Israel is not the most appropriate forum in which to bring such a claim. Even if an Israeli court agrees to hear a claim, it may determine that Israeli law is applicable to the claim. Certain matters of procedures will also be governed by Israeli law.

Israeli law may delay, prevent or make difficult a merger with, or an acquisition of us, which could prevent a change of control and therefore depress the price of our shares.

Provisions of Israeli law may delay, prevent or make undesirable a merger or an acquisition of all or a significant portion of our shares or assets. Israeli corporate law regulates acquisitions of shares through tender offers and mergers, requires special approvals for transactions involving significant shareholders and regulates other matters that may be relevant to these types of transactions. These provisions of Israeli law could have the effect of delaying or preventing a change in control and may make it more difficult for a third party to acquire us, even if doing so would be beneficial to our shareholders. These provisions may limit the price that investors may be willing to pay in the future for our ordinary shares. Furthermore, Israeli tax considerations may make potential transactions undesirable to us or to some of our shareholders.

Under current Israeli law, we may not be able to enforce covenants not to compete and therefore may be unable to prevent our competitors from benefiting from the expertise of some of our former employees.

We currently have non-competition clauses in the employment agreements of nearly all of our employees. The provisions of such clauses prohibit our employees, if they cease working for us, from directly competing with us or working for our competitors. Recently, Israeli courts have required employers, seeking to enforce non-compete undertakings against former employees, to demonstrate that the competitive activities of the former employee will cause harm to one of a limited number of material interests of the employer recognized by the courts (for example, the confidentiality of certain commercial information or a company s intellectual property). In the event that any of our employees chooses to leave and work for one of our competitors, we may be unable to prevent our competitors from benefiting from the expertise our former employee obtained from us, if we cannot demonstrate to the court that we would be harmed.

ITEM 4: INFORMATION ON THE COMPANY

OUR BUSINESS

We are a leading global provider of Internet Protocol, or IP, based digital satellite communication and networking products and services. We design, produce and market VSATs, or very small aperture terminals, and related VSAT network equipment. VSATs are earth-based terminals that transmit and receive broadband, Internet, voice, data and video via satellite. VSAT networks combine a large central earth station, called a hub, with multiple remote sites (ranging from tens to thousands of sites), which communicate via satellite. VSAT networks have significant advantages to wireline and wireless networks, as VSATs can provide highly reliable, cost-effective, end-to-end communications regardless of the number of sites or their geographic locations.

We have a large installed customer base and have shipped more than 750,000 VSAT units to customers in over 85 countries on six continents since 1989. We have 16 sales and service offices worldwide and two call centers to support our customers. Our products are primarily sold to communication service providers and operators that use VSATs to serve enterprise, government and residential users. Also, in the U.S. and certain countries in Latin America, we provide services directly to end users in various market segments.

We currently operate three complementary, vertically-integrated business units:

Gilat Network Systems, or GNS, is a provider of VSAT-based networks and associated professional services, including turnkey and management services, to telecom operators worldwide. According to the latest COMSYS VSAT Report, published in 2007 by Communications Systems Limited, or COMSYS (which refers to a market study from 2006), a leading satellite industry research firm, we are the second-largest manufacturer of VSATs, with a 23.5% market share of shipped VSATs and the leading provider to the international market (comprised of all countries other than the U.S. and Canada). We also provide industry specific solutions for cellular backhaul, business continuity and disaster recovery. In the year ended December 31, 2008, we derived approximately 51% of our revenues from GNS. GNS s representative customers include Brazil Telecom, Optus in Australia, Bharti in India, ICE in Costa Rica, Nepal Telecom, Telkom in South Africa and Telefonica in Latin America.

Spacenet Inc., or Spacenet, provides satellite and hybrid terrestrial network services to enterprise, government, small office/home office, or SOHO, and residential customers in the U.S. Spacenet provides three primary lines of service: custom networks, commercial grade service known as Connexstar, and StarBand service. According to the COMSYS report, we have a 19.5% market share of U.S. VSAT enterprise sites. In the year ended December 31, 2008, we derived approximately 40% of our revenues from Spacenet. Spacenet s representative customers include Dollar General, Goodyear, Intercontinental Hotels Group, USPS/Verizon, Scientific Games, Intralot, Boston Market, Valero, Sunoco and Kroger.

Spacenet Rural Communications, or SRC, provides telephony, Internet and data services primarily for rural communities in emerging markets in Latin America under projects that are subsidized by government entities. We believe that we are the largest rural satellite telecom provider in Latin America, and currently have approximately 16,000 operational sites. In the year ended December 31, 2008, we derived approximately 9% of our revenues from SRC.

We have diversified revenue streams that result from both sales of products and services. In the year ended December 31, 2008, approximately 56% of our revenues were derived from product sales and 44% from services. Our service revenues are derived from long-term contracts of three to six years, which provide stability and visibility into future revenues. As of December 31, 2008, we had a backlog of $195 million for equipment and multi-year service contracts. During the same period, we derived 40% of our revenues from the U.S., 27% from South and Central America, 15% from Asia, 13% from Africa and 5% from Europe.

We were incorporated in Israel in 1987 and shipped our first generation VSAT in 1989. Since then, we have been among the technological leaders in the VSAT industry. Our continuous investment in research and development has resulted in the development of new and industry-leading VSAT products and our intellectual property portfolio includes 60 issued patents (27 U.S. and 33 foreign). As of December 31, 2008, we had 966 employees, including 163 persons engaged in research, development and engineering activities.

Industry Overview

Satellite networks are comprised of multiple ground stations that communicate through a satellite in orbit, providing continent-wide wireless connectivity. VSAT networks are used to provide a variety of connectivity applications such as broadband data, video and voice. VSAT networks are usually deployed in a hub-and-spoke configuration, with customer locations connecting via satellite to a central hub facility. The value chain of VSAT satellite networks consists of the following four main elements:

Satellite operators provide satellite transponder capacity on satellites positioned in geostationary orbit above the equator. Once in orbit, a satellite beam can typically service a geographic area the size of the continental U.S. or larger. The satellite receives information from a VSAT or the network hub, amplifies it and transmits it back to earth on a different frequency. Satellite operators sell the capacity in a variety of leasing agreements to their customers. The current generation of high-power satellites uses Ku-band frequencies. Other frequencies are C-band and the more recently introduced Ka-band which usually operates on a multi-beam configuration. Our technology is compatible with C-band, Ku-band and Ka-band satellites including special extended C-band and extended Ku-band satellites. Some of the leading satellite operators are Intelsat, SES and Eutelsat.

Ground station equipment providers manufacture VSAT network equipment that combine a large central earth station, called a hub, with multiple remote sites (ranging from tens to thousands of sites) which communicate via satellite. GNS is a leading ground station equipment provider.

Communication service providers buy equipment from ground station equipment providers, install and maintain such equipment, lease capacity from satellite operators and sell a full package of communication services to the end user. Spacenet and SRC are leading communication service providers in the U.S. and Latin America, respectively.

End users are customers that use equipment and satellite communication services. Examples of end users range from enterprises, to governments, to residential consumers.

VSAT networks have a diverse range of uses and applications, and provide communication services as a stand-alone, alternate to, or complementary to wireline and wireless networks. We believe that the advantages of VSAT networks include:

Universal availability VSATs provide service to any location within a satellite footprint.

Timely implementation Large networks can be deployed within a few weeks.

Broadcast and multicast capabilities Satellite is an ideal solution for broadcast and multicast transmission as the satellite signal is simultaneously received by any group of users in the satellite footprint.

Reliability and service availability VSAT network availability is high due to the satellite and ground equipment reliability, the small number of components in the network and terrestrial infrastructure independence.

Scalability VSAT networks scale easily from a single site to thousands of locations.

Cost-effectiveness The cost of VSAT networks is independent of distance and therefore it is a cost-effective solution for networks comprised of multiple sites in remote locations.

Applications delivery Wide variety of customer applications such as e-mail, virtual private networks, or VPN, video, voice, Internet access, distance learning, content distribution and financial transactions.

Portability VSAT solutions can be mounted on vehicles or deployed rapidly in fixed locations, then relocated or moved as required.

Given the technological and implementation benefits afforded by VSAT networks, we believe that the market for VSAT products and services will continue to grow.

According to a Northern Sky Research report from 2008, the number of broadband satellite sites and subscribers is expected to grow at a compounded annual growth rate, or CAGR, of 14.2% through 2017. While the Northern Sky Research measures both consumer and enterprise sites, Gilat currently provides solutions primarily to the enterprise market.

According to the Northern Sky Research report, the global broadband satellite services market is expected to have a CAGR of 10.2% through 2011.

We believe that there are four primary categories of markets that require VSAT products and services:

Enterprise and Business. These end-users include large companies and organizations, government entities, small medium enterprises, or SMEs, and SOHO end users. For enterprises, VSAT networks offer network connectivity and deliver voice, data and video within corporations (known as corporate intranets), Internet access, transaction-based connectivity to enable on-line data delivery such as point-of-sale (credit and debit card authorization), inventory control and real time stock exchange trading. According to the Northern Sky Research report, SME base of two-way broadband VSAT sites accounted for 19% of the global installed base in 2007

High-End. The high-end market consists of customers that have more demanding requirements of network performance. These requirements usually include better level of Qualilty of Service, or QoS, than the typical user, higher speed connectivity, segregation of their traffic from other users traffic and more control over the network. Some examples of customers belonging to the high-end market are industrial energy organizations such as oil & gas and mining companies, militaries, maritime companies and mobile operators.

Rural Telecommunications. The rural telecommunications market is comprised of communities throughout the world that require telephone, facsimile and Internet access in areas that are underserved by existing telecommunications services. These communication services are usually provided to the rural population via government-subsidized initiatives. This market sector is comprised of Build-Operate projects, in which governments subsidize the establishment and the operation of a rural network to be served by a satellite, wireless or cellular service provider that is usually selected in a bid process. According to the 2006 GSM Association Universal Access Report, 57 out of the 92 emerging market and developing countries sampled for their study have plans to establish universal service funds, or USFs, within their jurisdictions to meet local telephony and Internet service requirements. According to this report, the USFs jointly collected approximately $6.0 billion worldwide through 2006, out of which $1.62 billion has been redistributed to the telecommunications industry. In other instances, local communications operators have USOs which require them to serve rural areas lacking terrestrial infrastructure. Some local communications operators elect to fulfill this obligation by hiring third parties in a model known as Build-Operate-Transfer. In these instances, the network is established and made operational by a third party service provider and then transferred to the operator.

Consumer. The consumer market consists of residential users. These users require a high-speed internet connection similar to a digital subscriber line, or DSL, or cable modem service. According to the Northern Sky Research report, in 2008 83% of these sites were located in North America.

Our Competitive Strengths

We are a leading provider of satellite communication and networking products and services. Our competitive strengths include:

Market leadership in large and growing markets. Since our inception, we have sold more than 750,000 VSATs to customers in over 85 countries. Our customer base includes a large number of satellite-based communications service providers and operators worldwide. In addition, we provide satellite-based communication services primarily to enterprises in the U.S. and we are the largest satellite communications service provider to rural communities in Latin America. The large installed base of our VSAT equipment also provides opportunities for new and incremental sales to existing customers. According to the latest COMSYS report, our global market share to the enterprise market was approximately 23.5%, based on the number of terminals shipped, making us the second largest VSAT manufacturer in the world for this segment.

Technology leadership. We have been at the forefront of VSAT technology and services for 20 years and continue to be an innovator and developer of new satellite technologies. Our highly customizable single platform VSAT technology enables us to provide our customers with a wide range of broadband, Internet, voice, data and video solutions and our product and operations infrastructure is capable of running hubs with greater than 99.99% availability while rolling out thousands of new VSAT site locations each month. We have unified all our legacy product lines under SkyEdge (currently we have a second generation of the platform SkyEdge II) which enables us to focus our research, development and engineering efforts that are supported by 163 persons. This enables us to rapidly develop new features and applications. In addition, by directly serving end-users through our service organizations, we are able to quickly respond to changing market conditions to ensure we maintain our leadership position.

Global presence and local support worldwide. We have sold our products in over 85 countries on six continents. Our products and services are used by a large and diverse group of customers including some of the largest enterprises in the world, several government agencies and many rural communities. We have 16 sales and service offices worldwide. Through our network of offices we are able to maintain a two-tier customer support program offering local support offices and a centralized supply facility.

Complementary business lines. Our three business units, GNS, Spacenet and SRC, enable us to provide a full turnkey solution to our customers by integrating a diverse range of value-added products and services. Our offerings range from VSAT network equipment, installation, operation and maintenance to provide services ranging from broadband, Internet, voice, data and video to managed solutions that are highly flexible and customizable. Our business model enables us to be closely attuned to all of our customers needs and to rapidly adapt to changing market trends. Our VSAT-based networks often serve as a platform for the delivery of a complete system, providing versatile solutions for corporate enterprises, government agencies, SMEs, rural communities, SOHOs and consumers.

Diversified revenue streams and customer base. For the year ended December 31, 2008, approximately 56% of our revenues were generated from products and 44% from services. Our product sales are generally independent equipment orders which often generate maintenance contracts and additional opportunities for future product sales. Our service sales are characterized by long-term contracts that provide a recurring revenue base. In the year ended December 31, 2008, our three business units, GNS, Spacenet and SRC, accounted for 51%, 40% and 9% of our revenues, respectively. We are not overly dependent on any single customer, project or geographic region and no single customer accounted for more than 10% of our revenues.

Strong financial position. Our strong financial position allows us to compete effectively with other companies in our industry. As of December 31, 2008, our total cash was $168.9 million (total cash includes cash and cash equivalents, held to maturity marketable securities, restricted cash and restricted cash held by trustees less short terms bank credits) and we reduced our debt to $34.7 million as of December 31, 2008, from $40.4 million at December 31, 2007. Given the current economic environment our strong cash position gives us a competitive advantage in potential acquisitions and in ongoing business.

Experienced management team. Since July 2005, we have operated under a new management team as well as a new board of directors. Our Chairman and CEO, Amiram Levinberg, is a co-founder of our company and leads a highly experienced executive team of satellite industry veterans. Our new management has refocused our business strategy and continued our financial turnaround.

Our Growth Strategy

Our objective is to leverage our advanced technology and capabilities to:

Enhance our leadership position in our core markets. In the past two years, we have expanded our position in the VSAT market through the development of new products, solutions and services within our target markets. Through the development of our SkyEdge and SkyEdge II products and our end-to-end solution offerings, we are focused on providing innovative products and services required by our customers and end-users. Our research and development efforts will focus on reducing our costs and expanding our product portfolio with new product offerings.

Expand our presence across the communications value chain. We are a leading global provider of VSAT network equipment and services. Gilat is focused on providing more than VSAT equipment and services to our customers by offering a full turnkey service for the management and deployment of the project. In these cases we handle the project management, solution design, equipment procurement, deployment logistics, installation and integration, operational services, maintenance and support.

Focus on emerging markets. We have expanded our focus on rural and emerging markets. Traditionally, it has been considered too costly for service providers to provide full-terrestrial networks to these regions. As a result, many governments either require telecommunications operators to provide communications access through USOs to these communities or provide funding via USFs to subsidize the provision of these services. Available worldwide USF funding is estimated to be around $4 billion in approximately 15 countries. As this communications rollout is adopted, VSAT-based communication networks provide a high quality, cost-effective alternative to terrestrial, wireless and cellular systems. GNS focuses its sales efforts on offering solutions to service providers that are either being required by USOs to facilitate the rural expansion, or on offering solutions to service providers that are utilizing the subsidies created through USFs.

Focus on business continuity/emergency response. We addressed the area of business continuity and emergency response applications by providing secondary networks for continuous operations during network failures or natural disasters. Examples of solutions include integration of a mobile communications kit for a complete on-the-go communication network and Cisco s iComm offered by Spacenet and business continuity solutions such as Cisco s VSAT Network Module and standalone VSATs that provide near-instantaneous failover from a primary circuit to the satellite backup.

Enter new strategic markets. We have identified a number of markets which we believe will be strategic to our future growth, including Broadband Wireless Access, or BWA, solutions and additional government markets. BWA is an emerging technology designed to solve the last mile connectivity problem of rural and remote locations that lack the terrestrial infrastructure. Service providers are using BWA systems to provide a link between end users and communications networks. We have integrated WiMAX into our product portfolio through an OEM agreement and we are leveraging our established sales and distribution channels in order to offer solutions that combine satellite technology with WiMAX.

We also leverage our technology expertise to further develop customized VSAT products, applications and services for the government and government-supported sectors in additional territories. Many governments, including the U.S., require applications with specific communication parameters that are particularly well-suited for satellite networks based on cost and performance. These applications range from border control and sensitive military applications to distance learning and open classroom education programs.

Proactively evaluate acquisitions that will support and enable our growth strategy. As we continue to focus on expanding the target markets for our products, services and solutions, we may have opportunities to acquire companies or technologies that would be complementary or additive to our existing platform and global distribution channels. We will proactively, but selectively, evaluate opportunities to expand our business.

Our Business Units

Gilat Network Systems (GNS)

Overview

GNS is a leading global provider of network systems and associated professional services for satellite communications service providers. Our operational experience in large VSAT networks together with our local offices worldwide enables us to work closely and directly with those service providers. We provide VSAT communication equipment and solutions to the commercial, government and consumer markets.

Our SkyEdge product family, including the SkyEdge and SkyEdge II products allows us to deliver efficient, reliable and affordable broadband connectivity such as Internet, voice, data and video.

We also provide solutions tailored to the requirements of individual industries. Based on our open SkyEdge platform, our solutions provide added value to operators through better performance and integration as well as simpler deployment. One such solution is SkyAbis, which provides cost-effective cellular backhaul for rural communications.

We also support satellite networking through professional services, training and a full range of turnkey solutions and outsourced network operations including Build-Operate-Transfer for networking facilities.

GNS is headquartered in Petah Tikva, Israel and has 13 offices worldwide, with 483 employees. In the year ended December 31, 2008, GNS had revenues of $161.9 million, including sales of $25.3 million to Spacenet and SRC.

Products and Solutions

SkyEdge Family of Products

Our SkyEdge product family is based on a single hub with multiple VSATs to support a variety of services and applications. The products were designed using advanced technology to enable them to process different types of user traffic such as voice, critical data, Internet traffic and video, to handle each type of traffic in an efficient manner and provide the necessary quality of service for each traffic stream. The SkyEdge also includes advanced mechanisms that ensure that the transmissions via the satellite utilize the available satellite bandwidth efficiently and enhance the user experience.

Below is a table that shows the main VSAT products Gilat offers. All of these products are connected to an outdoor RF unit which is mounted on a dish antenna:

Compact IP VSAT

IP

Internet access

ISPs, Consumers

Enterprise VSAT

IP

Internet access,
VoIP, LAN interconnect

SOHO, SME

Telco-grade Modular,
Rack-Mounted
Multi-Service VSAT

IP, voice, mesh

Internet access, LAN interconnect,
legacy voice, VoIP trunking, cellular
backhaul, video contribution

Enterprises, Government, Telecom,
Mobile Operators, Military

Modular
Multi-Service
VSAT

IP, voice, mesh

Internet access,
voice

Rural USO
projects

Outdoor VSAT

IP

Outdoor, IP traffic

Utilities, SCADA,
Security

Solutions

Our VSAT-based networks serve as a platform for the delivery of custom tailored solutions for identified markets. We pre-package, commercialize and sell these end-to-end solutions which offer higher value to our customers. For example, our SkyAbis supports a cellular backhaul application for Global System for Mobile Communications, or GSM, and Code Division Multiple Access, or CDMA, cellular-based stations. Our end-to-end solutions include government communication infrastructure solutions for post offices, elections, military and security and rapid VSAT deployment. We also provide turnkey solutions that include installation, operation and third-party peripheral equipment.

We currently offer the following specialized solutions:

Solution	SkyAbis	Disaster Recovery / Rapid Deployment	Cisco VSAT NM
Description	Cellular traffic backhaul enabling operators to expand their market reach	Transportable and man-pack units, communication solution	Satellite based networking for Cisco router with Cisco VSAT NM
Typical Application	Cellular backhaul for GSM and CDMA networks	On-demand access to voice, data and video	Business continuity, Disaster recovery, Content distribution
Type of customers / verticals	GSM and CDMA cellular operators	Mobile medical units, Mobile ATM, Military and security forces, Fire and police units	Enterprise, Financial sector, Governments
Selected customers	Enitel (Nicaragua), TFL Fiji	Petrobras (Brazil), Netpresa (Mexico), CACI (U.S), H-E-B (U.S)	Cisco sales channel customers, Valero (U.S)

WiMAX Solutions

Gilat offers a comprehensive portfolio of fixed and mobile WiMAX solutions for licensed and license-free frequencies. The product offering, which is provided through an OEM agreement, enables customers to address their broadband wireless access and satellite communications needs through Gilat, as an integrated one-stop-shop solutions provider. The VSAT and WiMAX platforms have been integrated with each other so that a customer deploying this integrated solution will have a common Quality of Service, or QoS for the systems and the WiMAX equipment can be managed via the VSATs.

Turnkey Implementation Capabilities

We provide our customers with end-to-end solutions which include the following:

Project management accompanying the customer through all stages of a project and ensuring that the project objectives are within the predefined scope, time and budget;

Network design translating the customer s requirements into a system to be deployed, performing the sizing and dimensioning of the system and evaluating the available solutions;

Deployment logistics - transportation and rapid installation of equipment in all of the network sites;

Implementation and integration combining our equipment with third party equipment such as solar panel systems and surveillance systems as well as developing tools to allow the customer to monitor and control the system;

Operational services providing professional services, program management, network operations and field services;

Maintenance and support providing 24/7 helpdesk services, on-site technician support and equipment repairs and updates.

24

Manufacturing, Customer Support and Warranty

Our products are designed and tested primarily at our facilities in Israel. We outsource a significant portion of the manufacturing of our products to third parties. We also work with third-party vendors for the development and manufacture of components integrated into our products, as well as for assembly of components for our products.

We offer a customer care program, which we refer to as SatCare, and professional services programs that improve customer network availability through ongoing support and maintenance cycles. As part of our professional services, we provide:

Outsourced operations such as VSAT installation, service commissioning and hub operations.

Proactive troubleshooting, such as periodic network analysis, to identify symptoms in advance.

Training and certification to ensure customers and local installers are proficient in VSAT operation.

We typically provide a one-year warranty to our customers as part of our standard contract.

GNS Customers and Markets

We sell VSAT communications networks and solutions primarily to service providers. The service providers to whom we sell our products and solutions are primarily serving the enterprise market. We have more than 200 customers worldwide.

Enterprise and service providers use our networks for Internet access, for broadband data, voice and video connectivity and for applications such as credit card authorizations, online banking, corporate intranet, interactive distance learning, lottery transactions, retail point-of-sale, inventory control and Supervisory Control and Data Acquisition, or SCADA, services.

Service providers serving the rural communications market are typically public telephony and Internet operators providing telephony and Internet services through public call offices, telecenters, Internet cafes or pay phones. Some of the rural communication projects are for government customers. Examples of our rural telecom customers include Nepal Telecom and ICE in Costa Rica.

Our VSAT networks also provide underserved areas with a high-speed Internet connection similar to DSL service provided to residential users. An example of such a customer is Optus in Australia.

GNS Sales and Marketing

We use both direct and indirect sales channels to market our products, solutions and services. Most of our revenues are derived from direct sales. Our GNS equipment sales division has organized its marketing activities by geographic areas, with groups or subsidiaries covering most regions of the world. Our sales teams are comprised of account managers and sales engineers (approximately 150 employees), who establish account relationships and determine technical and business requirements for the network. These teams also support the other distribution channels with advanced technical capabilities and application experience. Sales cycles in the VSAT network market vary significantly, with some sales requiring 18 months from an initial lead through signing of the contract and others stemming from an immediate need for product delivery within two to three months. The sales process includes understanding customer needs, several network design iterations, and network demonstrations.

Spacenet Inc.

Overview

Spacenet provides satellite network services to enterprise, government, and small office/home office (SOHO) customers in North America. In addition, we offer our enterprise customers value-added services, including hybrid satellite/terrestrial networks, VoIP, and outsourced network management.

Spacenet s equipment and services are currently deployed at more than 100,000 business, government and residential locations in the U.S. Our customers include Dollar General, Goodyear, Intercontinental Hotels Group, USPS/Verizon, Scientific Games, Intralot, Boston Market, Kroger, Sunoco and Valero. The latest COMSYS report, ranked Spacenet as the second largest satellite network service provider in North America for the enterprise/government market, with a19.5% market share. Our market includes WAN services for retail, energy, oil & gas, financial services, hospitality and government customers, as well as Internet access services for SOHO and residential customers.

Spacenet is based in McLean, Virginia, and has 245 employees. In the year ended December 31, 2008, Spacenet had revenues of $106.3 million.

Services

Spacenet offers prepackaged and custom network services that are sold under the Spacenet, Connexstar and StarBand brand names. These service lines target a variety of markets and applications, as is illustrated in the diagram below:

Service	***StarBand***	***Connexstar Transaction***	***Connexstar Broadband***	***Connexstar Performance***	***Spacenet Custom Networks***
Description	VSAT Internet access services	Low-bandwidth VSAT network	Commercial grade broadband VSAT networks	High-bandwidth VSAT network	VSAT and hybrid terrestrial WANs
Typical applications	Web, E-mail	Credit cards, Point-of-sale, SCADA	Intranet, Credit cards, Back-office applications	VoIP, Video monitoring, Backup networks	Web Based Business Applications, Corporate E-mail, VoIP, Video, Multicast-based file delivery applications
Target Markets	SOHOs	Utilities pipeline networks, Lottery operators	Retail Hospitality, Small business	Disaster recovery, Business continuity, government, Energy exploration	Large enterprise customers
Sample Customers	Residential users	Texas Utilities, Avista Utilities, Georgia Transmission Corp.	FedEx Ground, LandTel, Orbital Data Networks	State and Local Government. Valero	Dollar General, USPS/Verizon, OneOk

Spacenet s custom network services for large enterprise and government customers provide secure private networks specifically sized and tuned to a customer s application, protocol support, QoS and bandwidth needs. These networks may be delivered as a private hub (each set of hub baseband equipment is used for only one customer) or virtual private hub (hub equipment is shared among multiple customers but is logically partitioned to provide private hub benefits at a lower cost). Custom network configurations also include hybrid terrestrial/satellite networks in which Spacenet provides management of both network components, integrating them as a single WAN.

Spacenet s standard Connexstar services are optimized for popular customer applications, and are engineered to provide superior performance compared to other providers one size fits all solutions. Connexstar services are offered in full-time plans for primary network use or as on-demand services for emergency response and business continuity use.

These services are also available in fixed site or transportable configurations for on-the-go communications. All of Spacenet s custom network and standard Connexstar services offer Service Level Agreements, or SLAs, for network reliability, network management and reporting tools, professional program management and implementation assistance, and professional-grade installation and maintenance options.

Network Operations and Customer Support

We operate teleport facilities with Network Operation Centers, or NOCs, in Chicago, Illinois, and Marietta, Georgia. Our operations staff of more than 100 persons supervises network implementation and installation quality assurance, manages shared-hub and private-hub networks, provides first-level and escalated help desk/problem resolution, manages inventory and shipping, and dispatches field service/maintenance technicians. The Chicago NOC facility specializes in operation of high-availability networks for our largest enterprise and government customers. The Marietta NOC facility operates our Connexstar and StarBand services as well as first and second-level call centers. The McLean headquarters facility provides pilot and disaster recovery hub operations, third-tier network escalation and advanced network management services.

For enterprise and government satellite networks, we offer SLAs providing guarantees on network uptime and availability as well as guaranteed network performance and issue resolution time. Spacenet s network management and operations features include diverse and scalable hub and satellite options, centralized network management center, extensive web-based tools for customers, dedicated program management and service automation.

Spacenet Sales and Marketing

We sell our enterprise and government services directly through a team of account executives as well as through a network of approximately 30 authorized enterprise service resellers, primarily telecom carriers, IT integrators and value-added resellers focused on specific industries.

Our StarBand SOHO services are sold both directly and through approximately 150 sales agents, that are typically direct-to-home satellite TV resellers and/or satellite Internet service resellers. Our distribution channel strategy is shown below:

Spacenet Rural Communications

Overview

SRC is a service provider for public telephony and Internet services to rural areas in Latin America, mainly in Peru and Colombia. In these countries, we have built the infrastructure and act as an operator (Build-and-Operate model) in subsidized government projects. Our services include operating public phones and telecenters and distributing pre-paid cards for telephone usage at remote villages. In addition, SRC uses its infrastructure to provide services to enterprise, SME, SOHO and residential customers. SRC also provides outsourcing of VSAT network implementation and operation to other operators in the region.

SRC has offices in Peru and Colombia and employs 255 persons. In the year ended December 31, 2008 SRC had revenues of $24.5 million

SRC Services and Solutions

We began to operate in Peru in 1998, with the award of our first rural telephony project called Frontera Norte for FITEL, with approximately 200 sites. Since then, we have participated in almost every rural communications project launched by the Peruvian government and have won, either wholly or partially, all seven projects. Overall, we operate almost 6,000 telephony sites in Peru, of which approximately 600 have Internet connectivity, and have been awarded over $45 million in government subsidies to build and operate these networks. In addition, we have developed services for private customers, such as Banco de la Nacion, utilizing our current infrastructure and providing those customers with Internet, data and telephony services. Our rural network manages millions of incoming and outgoing minutes every month, serving more than six million people in rural areas. On average, the network in Peru has reduced the distance between rural phone locations from 50km to 5km.

SRC Colombia started operations in 1999 by winning the government s Compartel I project focused on rural telephony. Since then we have been awarded two additional projects with over $100 million in government subsidies in the aggregate.

Currently, SRC Colombia operates a network of almost 9,000 rural sites spread throughout the country, serving over seven million persons. The services for those rural sites include telephony, Internet, data, fax and other services. In order to comply with government bid requirements, SRC has integrated a variety of technologies into its VSAT based network such as wireless local loop and cellular. The number and mix of these sites is changing in order to meet the requirements of the newly revised agreements with the Ministry of Communications in Colombia.

In addition to its well established operations in Peru and Colombia, SRC provides services to customers in other countries in the region. In Panama, SRC is working with Cable & Wireless to allow it to fulfill its USO with cost efficient technology and high quality service.

Customer Support Operations

SRC complements its services with back office support for subsidized telephony and Internet networks as well as for private Internet, data and telephony clients including a call center, network operations center, field service maintenance and a pre-paid calling card platform and distribution channels.

SRC Customers and Markets

Public Rural Telecom Services:

In a large number of remote and rural areas, primarily in developing countries, there is limited or no telephone or Internet service, due to inadequate terrestrial telecommunications infrastructure. In these areas, VSAT networks utilize existing satellites to rapidly provide high-quality, cost-effective telecommunications solutions. In contrast to terrestrial networks, VSAT networks are simple to reconfigure or expand, relatively immune to difficulties of topography and can be situated almost anywhere. Additionally, VSATs can be installed and connected to a network quickly without the need to rely on local infrastructure. For example, some of our VSATs are powered by solar energy where there is no existing power infrastructure. Our VSATs provide reliable service, seldom require maintenance and, when necessary, repair is relatively simple.

As a result of the above advantages, there is a demand for government-sponsored, VSAT-based bundled services of fixed telephony and Internet access. Many of these government-funded projects have been expanded to provide not only telephony services and Internet access, but to also provide telecenters that can serve the local population. These telecenters typically include PCs, printers, fax machines, photocopiers, VCRs and TVs for educational programs. Additional revenue may be received, both in the form of subsidies and direct revenues from the users, when these additional services are provided. Our rural telecom government customers are Compartel in Colombia and FITEL in Peru.

VSAT Services to Telecom Operators:

In some markets, existing telecom operators are mandated by the government to provide universal services. Providing these services in remote areas is a challenge to these operators, and they sometimes outsource these services to rural telecom service providers. The exact nature of these outsourcing projects varies, but they are typically a Build-Transfer model or a Build-Operate-Transfer model. Cable & Wireless in Panama is SRC s first Build-Operate-Transfer customer.

Enterprise and Government Agencies:

We also provide private network services to selected enterprises and government agencies. These customers contract directly with SRC for VSAT equipment and associated network services to be deployed at customer locations, typically for a contract term of three to five years. We also resell managed terrestrial connectivity equipment and services from facilities-based Local Exchange Carrier partners. One such customer is Banco de la Nacion in Peru.

SRC Sales and Marketing

We use direct sales channels to market our services. Our sales team of account managers and sales engineers are the primary account interfaces and work to establish account relationships and determine technical and business demands.

Competition

The telecommunications industry is a competitive market. In the equipment market, GNS faces competition from other VSAT manufacturers, such as Hughes Network Systems LLC, ViaSat, iDirect and a few other smaller manufacturers.

The U.S. enterprise VSAT market is primarily served by Spacenet and Hughes Network Systems LLC. In addition, more recently, Spacenet s primary competitors in the enterprise WAN market are large terrestrial carriers such as AT&T, Verizon and Qwest.

In Peru and Colombia, where we primarily operate public rural telecom services, we typically encounter competition on government subsidized bids from various service providers, system integrators and consortiums. Some of these competitors offer solutions based on VSAT technology and some on alternate technologies (typically cellular, wireless local loop or WiMAX). As operators that offer terrestrial or cellular networks expand their reach to certain SRC regions, they compete with our VSAT solutions.

Geographic Distribution of our Business

The following table sets forth our revenues by geographic area for the periods indicated below as a percent of our total sales:

	Years Ended December 31,		
	2008	**2007**	**2006**
United States	39.9%	33.9%	37.8%
South America and Central America	27.5%	26.9%	32.0%
Asia	14.8%	14.0%	15.3%
Africa	13.3%	12.3%	7.5%
Europe	4.5%	12.9%	7.4%
Total	100.0%	100.0%	100.0%

Capital Expenditures and Divestitures. In 2008, 2007 and 2006, our property and equipment purchases amounted to approximately $13.8 million, $9.3 million and $6.5 million, respectively. These amounts do not include the reclassification of inventory to property and equipment made during 2008, 2007 and 2006 in the amount of approximately $3.4 million, $2.2 million and $9.2 million, respectively. On March 1, 2006 we and SES, a leading satellite space segment provider, executed an agreement whereby we transferred our remaining 0.17% interest in Satlynx to SES. As part of this agreement, we received a waiver from SES on any royalty payments which may be payable by us to SES in accordance with development agreements signed between the parties in 2002 and SES provided a corporate guarantee to cover Satlynx s obligations to us.

Backlog

On December 31, 2008, our backlog for equipment sales and revenues from multi-year service contracts for our VSAT products was approximately $195 million, down from approximately $202 million at year-end 2007. Backlog does not include revenues from future traffic on our rural networks, future revenues from subscribers from our consumer and enterprise operation and other cancelable agreements. Backlog is not necessarily indicative of future sales. Many of our contracts can be terminated at the convenience of the customer. In addition, some of our contracts may include product specifications that require us to complete additional product development. Any inability to meet the specifications or complete the product development could lead to a termination of the related contract.

Facilities

Our headquarters are located in a modern office park which we own in Petah Tikva, Israel. This facility is comprised of approximately 380,000 square feet of office space.

We have network operations centers in Marietta, Georgia and shared hub facilities in Chicago, Illinois, Peru and Colombia, from which we perform network services and customer support functions 24 hours a day, 7 days a week, 365 days a year.

We lease approximately 137,000 square feet of office space in McLean, Virginia. These offices house our personnel and also contain a stand by disaster recovery facility. In 2000 and 2002, we purchased and developed facilities on approximately 140,400 square feet of land in Backnang, Germany. Since May, 2002, these facilities are leased to a third party.

We also maintain facilities in Chicago, Illinois, Marietta, Georgia and in Brazil, Colombia, Mexico, and Peru, along with representative offices in Melbourne, Pretoria, Bangkok, New Delhi, Almaty, Jakarta and Moscow and small facilities in other locations throughout the world.

We believe our facilities to be adequate for our needs.

ITEM 4A: UNRESOLVED STAFF COMMENTS

There are no unresolved staff comments.

ITEM 5: OPERATING AND FINANCIAL REVIEW AND PROSPECTS

A. Operating Results

The following discussion of our results of operations should be read together with our audited consolidated financial statements and the related notes, which appear elsewhere in this annual report. The following discussion contains forward-looking statements that reflect our current plans, estimates and beliefs and involve risks and uncertainties. Our actual results may differ materially from those discussed in the forward-looking statements. Factors that could cause or contribute to such differences include those discussed below and elsewhere in this annual report.

Introduction

We were incorporated in 1987 and began trading on the NASDAQ Stock Market in 1993. We are a leading global provider of Internet Protocol, or IP, based digital satellite communication and networking products and services. We design, produce and market VSATs, or very small aperture terminals, and related VSAT network equipment. VSATs are earth-based terminals that transmit and receive broadband, Internet, voice, data and video via satellite. VSAT networks have significant advantages to wireline and wireless networks, as VSATs can provide highly reliable, cost effective, end-to-end communications regardless of the number of sites or their geographic locations.

We have a large installed customer base and have shipped more than 750,000 VSAT units to customers in over 85 countries on six continents since 1989. We have 16 sales and service offices worldwide and two call centers to support our customers. Our products are primarily sold to communication service providers and operators that use VSATs to serve enterprise, government and residential users. Also, in the U.S. and certain countries in Latin America, we provide services directly to end-users in various market segments.

We currently operate three complementary, vertically-integrated business units: Gilat Network Systems, or GNS, a provider of VSAT-based networks and associated professional services, including turnkey and management services, to telecom operators worldwide; Spacenet Inc. a provider of satellite network services to enterprises, small office/home office, or SOHOs, and residential customers in the U.S.; and Spacenet Rural Communications, or SRC, a provider of telephony, Internet and data services primarily for rural communities in emerging markets in Latin America under projects that are subsidized by government entities.

Financial Statements in U.S. dollars

The currency of the primary economic environment in which most of our operations are conducted is the U.S. dollar and, therefore, we use the U.S. dollar as our functional and reporting currency. Transactions and balances originally denominated in U.S. dollars are presented at their original amounts. Gains and losses arising from non-U.S. dollar transactions and balances are included in the consolidated statements of operations. The financial statements of foreign subsidiaries, whose functional currency has been determined to be their local currency, have been translated into U.S. dollars. Assets and liabilities have been translated using the exchange rates in effect at the balance sheet date. Statements of operations amounts have been translated using the average rates, which approximate the prevailing exchange rate for each transaction. The resulting translation adjustments are reported as a component of shareholders equity in accumulated other comprehensive income (loss).

Critical Accounting Policies and Estimates

The preparation of the financial information in conformity with generally accepted accounting principles requires us to make estimates and judgments that affect the reported amounts of assets, liabilities, revenues and expenses, and related disclosure of contingent assets and liabilities. On an ongoing basis, we evaluate our estimates, mainly related to account receivables, inventories, deferred charges, long-lived assets, revenues, stock based compensation relating to options and contingencies. We base our estimates on historical experience and on various other assumptions, including assumptions of third parties that are believed to be reasonable under the circumstances, the results of which form the basis for making judgments about the carrying values of assets and liabilities that are not readily apparent from other sources. Actual results may differ from these estimates.

We believe the following critical accounting policies affect our more significant judgments and estimates used in the preparation of the financial information included in this annual report.

Revenues. We generate revenues mainly from the sale of products and services for satellite-based communications networks. Sale of products includes mainly the sale of VSATs and hubs. Service revenues include access to and communication via satellites, or space segment, installation of network equipment, telephone services, internet services, consulting, on-line network monitoring, network maintenance and repair services. We sell our products primarily through our direct sales force and indirectly through resellers. Sales consummated by our sales force and sales to resellers are considered sales to end-users.

Revenues from product sales are recognized in accordance with SEC Staff Accounting Bulletin, or SAB, No. 104, Revenue Recognition , or SAB No. 104, when delivery has occurred, persuasive evidence of an agreement exists, the vendor s fee is fixed or determinable, no further obligation exists and collectability is probable. When significant accepted provision is included in the arrangement revenues are deferred until the acceptance occurs. Generally, we do not grant rights of return. Service revenues are recognized ratably over the period of the contract or as services are performed, as applicable.

In accordance with Emerging Issues Task Force, or EITF, Issue No. 00-21, Revenue Arrangements with Multiple Deliverables, or EITF 00-21, a multiple-element arrangement (an arrangement that involves the delivery or performance of multiple products, services and/or rights to use assets) is separated into more than one unit of accounting, if the functionality of the delivered element(s) is not dependent on the undelivered element(s), there is vendor-specific objective evidence (VSOE) of fair value of the undelivered element(s) and delivery of the delivered element(s) represents the culmination of the earnings process for those element(s). If these criteria are not met, the revenue is deferred until such criteria are met or until the period in which the last undelivered element is delivered. If there is VSOE for all units of accounting in an arrangement, the arrangement consideration is allocated to the separate units of accounting based on each unit s relative VSOE.

Revenues from products under sales-type-lease contracts are recognized in accordance with SFAS No. 13, Accounting for Leases , or SFAS No. 13, upon installation or upon shipment, in cases where the customer obtains its own or other s installation services. The net investments in sales-type-leases are discounted at the interest rates implicit in the leases. The present values of payments due under sales-type-lease contracts are recorded as revenues at the time of shipment or installation, as appropriate. Future interest income is deferred and recognized over the related lease term as financial income.

Revenues from products and services under operating leases of equipment are recognized ratably over the lease period, in accordance with SFAS No. 13.

Deferred product revenue generally relates to acceptance provisions that have not been met, partial shipment or when our company does not have VSOE of fair value on the undelivered items. In general, when deferred revenues are recognized as revenues, the associated deferred costs are also recognized as cost of sales.

Cost of Revenues. Cost of revenues, for both products and services, includes the cost of system design, equipment, satellite capacity, customer service, interconnection charges and third party maintenance and installation. Generally, for equipment contracts, cost of revenues is expensed as revenues are recognized. For network service contracts, cost of revenues is expensed as revenues are recognized over the term of the contract. For maintenance contracts, cost of revenues is expensed as the maintenance cost is incurred over the term of the contract. At each balance sheet date, we evaluate our inventory balance for excess quantities and obsolescence. This evaluation includes an analysis of sales levels by product 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 for our old or new products or market conditions is less favorable than our projections, inventory write-offs may be required and would be reflected in cost of revenues for such period.

Income Taxes. In July 2006, the FASB issued Interpretation No. 48, Accounting for Uncertainty in Income Taxes (FIN 48). FIN 48 clarifies the accounting for uncertainty in income taxes recognized in an enterprise s financial statements in accordance with FAS 109. This interpretation prescribes a minimum recognition threshold a tax position is required to meet before being recognized in the financial statements. FIN 48 also provides guidance on derecognition of tax positions, classification on the balance sheet, interest and penalties, accounting in interim periods, disclosure and transition. FIN 48 requires significant judgment in determining what constitutes an individual tax position as well as assessing the outcome of each tax position. Changes in judgment as to recognition or measurement of tax positions can materially affect the estimate of the effective tax rate and consequently, affect the operating results of our company.

Accounts Receivable and Allowance for Doubtful Accounts. We are required to estimate our ability to collect our trade receivables. A considerable amount of judgment is required in assessing their ultimate realization. We provided allowance for our receivables relating to customers that were specifically identified by our management as having difficulties paying their respective receivables. If the financial condition of our customers deteriorates, resulting in their inability to make payments, additional allowances may be required. These estimates are based on historical bad debt experience and other known factors. If the historical data we used to determine these estimates does not properly reflect future realization, additional allowances may be required.

Inventory Valuation. We are required to state our inventories at the lower of cost or market value. In assessing the ultimate realization of inventories, we are required to make judgments as to future demand requirements and compare that with the current or committed inventory levels.

Impairment of Intangible Assets and Long-Lived Assets. We periodically evaluate our intangible assets and long-lived assets for potential impairment indicators. Our judgments regarding the existence of impairment indicators are based on legal factors, market conditions and operational performance of our acquired businesses and investments. Our long-lived assets are reviewed for impairment annually and whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. Recoverability of assets to be held and used is measured by a comparison of the carrying amount of the assets to the future undiscounted cash flows expected to be generated by the assets. If such assets are considered to be impaired, the impairment to be recognized is measured by the amount by which the carrying amount of the assets exceeds the fair value of the assets. In measuring the recoverability of assets, we are required to make estimates and judgments in assessing our future cash flows which derive from the estimated useful life of our current primary assets, and compare that with the carrying amount of the assets. Additional significant estimates used by management in the methodologies used to assess the recoverability of our long-lived assets include estimates of future short-term and long-term growth rates, useful lives of assets, market acceptance of products and services, our success in winning bids and other judgmental assumptions, which are also affected by factors detailed in our risk factors section in this prospectus. If these estimates or the related assumptions change in the future, we may be required to record impairment charges for our long-lived assets.

Future events could cause us to conclude that impairment indicators exist and that additional intangible assets and long-lived assets associated with our acquired businesses and our long-lived assets are impaired. Any resulting impairment loss could have a material adverse impact on our financial condition and results of operations.

Most of the activity of Spacenet Rural in Colombia consists of operating subsidized projects for the government (the Compartel Projects). In accordance with these projects, the Colombian government transferred approximately $70 Million to trust accounts. The money is released from the trusts based on a schedule of payments and meeting certain operational milestones. As of December 31, 2008, approximately $51 million has been released from the trusts to our company and approximately $24 million is being held in trust with respect to these projects, until certain operational milestones imposed by the Colombian government are met. In December 2008, after lengthy negotiations with the Ministry of Communication in Colombia, we signed an addendum relating to the Compartel projects, modifying the operational milestones. The new terms of the agreements include the removal of thousands of telephony sites which were determined to no longer be needed or used by the rural population in Colombia, the upgrade of technology, primarily in existing sites, entailing additional capital expenditure, the modification of the terms of the agreements and a release by each of the parties from all prior claims under the previous agreements.

In order to guarantee our performance under the Compartel projects, we secured insurance from a local insurance company in Colombia. We have provided the insurance company with various corporate guarantees guaranteeing our performance and our employee salary and benefit cost for approximately of $27 million and $5 million respectively.

During 2008 and 2007 we deferred revenues related to the Compartel projects in the amount of approximately $14.8 and $6.4 million respectively, in order to ensure that accumulated revenues recognized from the Compartel Projects did not exceed the accumulated amounts already released from the trust. In general, we recognize revenues for these projects on a straight line basis, relative to the beginning of operation and for the period that service is required to be provided. The deferred revenues relate to periods for which we have already provided service but, due to not meeting the operational milestones, these amounts were not released from restricted cash.

In accordance with the guidelines of FASB 144, Accounting for the impairment or disposal of long lived assets , we recorded an impairment of long lived assets and other charges with respect to its projects in Colombia in amount of $5.0 million and $12.2 million in 2008 and 2007 respectively.

Legal and Other Contingencies. We are currently involved in certain legal and other proceedings and are also aware of certain tax and other legal exposures relating to our business. We are required to assess the likelihood of any adverse judgments or outcomes of these proceedings or contingencies as well as potential ranges of probable losses. A determination of the amount of accruals required, if any, for these contingencies is made after careful analysis. The accounting treatment related to income taxes exposure/ contingencies have been assessed and provided in accordance with SFAS No. 109, Accounting for Income Taxes (SFAS 109) and FASB issued Interpretation No. 48, Accounting for Uncertainty in Income Taxes (FIN 48). Liabilities related to legal proceedings, demands and claims are recorded in accordance with the Statement of Financial Accounting Standards No. 5, Accounting for Contingencies, or SFAS No. 5. SFAS No. 5 defines a contingency as an existing condition, situation, or set of circumstances involving uncertainty as to possible gain or loss to an enterprise that will ultimately be resolved when one or more future events occur or fail to occur. In accordance with SFAS No. 5, accruals for exposures or contingencies are being provided when the expected outcome is probable and when the amount of loss can be reasonably estimated. It is possible, however, that future results of operations for any particular quarter or annual period could be materially affected by changes in our assumptions, the actual outcome of such proceedings or as a result of the effectiveness of our strategies related to these proceedings.

Accounting for Stock-Based Compensation. On January 1, 2006, we adopted the provisions of Statement of Financial Accounting Standard (SFAS) No. 123(R), Share-Based Payment, which requires us to measure all employee stock-based compensation awards using a fair value method and recognize such expense in our consolidated financial statements. We adopted SFAS 123(R) using the modified prospective transition method, which requires the application of the accounting standard starting from January 1, 2006. We estimate the fair value of stock options granted using the Black-Scholes option pricing model. Prior to the adoption of SFAS 123(R), we accounted for equity-based awards to employees and directors using the intrinsic value method in accordance with APB No. 25, Accounting for Stock Issued to Employees (APB 25) as allowed under SFAS 123. Non-cash share-based compensation of $0.7 million was recorded in 2008. As of December 31, 2008, we had $4.7 million of total unrecognized compensation costs related to non-vested share-based awards granted under our stock option plans. That cost is expected to be recognized over a weighted average period of 2.1 years.

Year Ended December 31, 2008 Compared to Year Ended December 31, 2007

Revenues. Revenues for the year ended December 31, 2008 and 2007 for our three business segments were as follows:

	Year Ended December 31,			Year Ended December 31,	
	2008	2007	Percentage	2008	2007
	U.S. dollars in thousands		change	Percentage of revenues	
GNS					
Equipment	$ 136,500	$ 147,665	(7.6)%	50.8%	52.2%
Services	25,420	23,754	7.0%	9.7%	8.4%
	161,920	171,419	(5.5)%	60.5%	60.6%
Spacenet					
Equipment	38,950	26,513	46.9%	14.6%	9.4%
Services	67,410	68,857	(2.1)%	25.2%	24.4%
	106,360	95,370	11.5%	39.8%	33.8%
SRC					
Equipment	169	268	(36.8)%	0.1%	0.1%
Services	24,373	33,922	(28.1)%	9.1%	12.0%
	24,542	34,190	(28.2)%	9.2%	12.1%
Intercompany Adjustments					
Equipment	25,268	17,649	43.2%	9.4%	6.2%
Services	28	711	(96.3)%	0.1%	0.3%
	25,296	18,360	37.8%	9.5%	6.5%

	Year Ended December 31,			Year Ended December 31,	
Total					
Equipment	150,351	156,797	(4.1)%	56.0%	55.5%
Services	117,175	125,822	(6.9)%	44.0%	44.5%
Total	267,526	282,619	(5.3)%	100%	100.0%

Revenues in 2008 decreased by 5.3% compared to 2007. Revenues in 2008 were derived 56.2% from equipment and 43.8% from services. In 2007, our revenues were derived 56.0% from equipment and 44.0% from services. The decrease in the service portion of our business in 2008 is attributable to the $14.8 million reduction in revenues recognized by SRC, relating to the delay in the release of restricted cash from the Compartel projects in Colombia, while in 2007 we recognized revenues of approximately $8.5 million with respect to these projects. In addition the decline in revenues is also attributable to longer sales cycles in the emerging markets and more conservative spending in the telecom sector, which we attribute primarily to the economic recession affecting markets worldwide. The decrease in our revenues was partially offset by Spacenet s activities including the continued roll-outs of large-scale gaming networks in the U.S. Results for revenues in the year 2009 will be affected by the Company s ability to overcome the economic recession and generate sales in a more difficult economic environment as well as upon the Company s ability to perform under the new agreements in Colombia and collect the restricted cash associated therewith.

Gross profit. The gross profit of our three business segments for the years ended December 31, 2008 and 2007 was as follows:

	Year Ended December 31,		Year Ended December 31,	
	2008	2007	2008	2007
	U.S. dollars in thousands		Percentage of revenues per segment	
GNS				
Equipment	$ 58,547	$ 72,064	42.9%	48.8%
Services	8,354	13,028	32.9%	54.8%
	$ 66,901	$ 85,092	41.3%	49.6%
Spacenet				
Equipment	$ 11,704	$ 3,449	30.0%	13.0%
Services	8,952	11,097	13.3%	16.1%
	$ 20,656	$ 14,546	19.4%	15.3%
SRC				
Equipment	$ 43	$ 231	25.3%	86.2%
Services	(2,992)	2,089	(12.3)%	6.2%
	$ (2,949)	$ 2,320	(12.0)%	6.8%
Intercompany Adjustments	1,344	(113)	5.3%	0.6%
Total Gross Profit	$ 85,952	$ 101,845	32.1%	36.0%

Our gross profit margin decreased to approximately 32.1% in 2008, from 36.0% in the year ended 2007. The decrease is partially attributable to the projects in Colombia in which we continued to record all related expenses but did not recognize the related revenues. In addition, GNS gross margin decreased from 49.6% in 2007 to 41.3% in 2008, also contributing to the overall decrease in our gross margin. The decrease in GNS gross margin is attributable to an increase in transactions in 2008 in regions carrying lower margins such as Asia and Latin America versus higher gross margin transactions in 2007 from Eastern Europe. In addition, during 2008 we wrote off approximately $1.5 million of excess inventory relating mainly to legacy equipment, compared to a write off of $0.5 million in 2007. The decrease in our gross profit was partially offset by an increase in Spacenet s gross profits due a higher level of revenues in 2008.

When reported by segment, the results of Spacenet and SRC are presented based upon intercompany transfer prices. The intercompany adjustments line reflects the intercompany profits that were realized in order to adjust the transfer price to our cost.

Research and Development Expenses:

	Year Ended December 31, 2008	2007	Percentage	Year Ended December 31, 2008	2007
	U.S. dollars in thousands		change	Percentage of revenues per segment	
GNS					
Expenses incurred	$ 18,702	$ 17,270	8.3%	11.6%	10.1%
Less - grants	1,760	2,240	(21.4)%	1.1%	1.3%
Total GNS	$ 16,942	$ 15,030	12.7%	10.5%	8.8%

Net research and development expenses increased by approximately $1.9 million in the year ended December 31, 2008 compared to the year ended December 31, 2007. The increase was mainly due to increased salaries and related expenses caused by the devaluation of the US Dollar against the NIS during 2008 and severance packages of approximately $0.5 million for employees leaving our company. In addition, during 2008, we received approximately $0.5 million less in grants due to the completion of a project with the European Union.

Selling and marketing expenses. The selling and marketing expenses of our three business segments for the years ended December 31, 2008 and 2007 were as follows:

	Year Ended December 31, 2008	2007	Percentage	Year Ended December 31, 2008	2007
	U.S. dollars in thousands		change	Percentage of revenues per segment	
GNS	$ 25,741	$ 27,205	(5.4)%	15.8%	15.8%
Spacenet	9,309	8,905	4.3%	8.8%	9.3%
SRC	733	2,264	(68)%	3.0%	6.6%
Total	$ 35,783	$ 38,374	(6.8)%	13.4%	13.5%

Selling and marketing expenses decreased by approximately $2.6 million in the year ended December 31, 2008, compared to the year ended December 31, 2007. This decrease is primarily attributable to a decrease of approximately $2.3 million in sales commissions and agent commissions, when compared to the year prior.

General and administrative expenses. The general and administrative expenses of our three business segments for the year ended December 31, 2008 and 2007 were as follows:

	Year Ended December 31, 2008	Year Ended December 31, 2007	Percentage	Year Ended December 31, 2008	Year Ended December 31, 2007
	U.S. dollars in thousands		change	Percentage of revenues per segment	
GNS	$ 14,712	$ 12,135	21.2%	9.1%	7.1%
Spacenet	8,939	12,979	(31.1)%	8.4%	13.6%
SRC	6,168	5,938	3.9%	25.1%	17.4%
Total	$ 29,819	$ 31,052	(4.0)%	11.1%	11.0%

General and administrative expenses decreased by approximately $1.2 million in 2008, compared to 2007. The decrease in Spacenet is attributable primarily to a reduction of approximately $0.9 million in sales and use tax provision made in 2007 due to a settlement with the tax authorities in 2008. In addition, during 2008 Spacenet s doubtful debt expenses decreased by approximately $0.8 million. The decrease in Spacenet s general and administrative expenses was offset by increased expenses in GNS as a result of the devaluation of the US Dollar against the NIS during 2008 and additional expenses of approximately $1.0 million in professional consulting fees relating to the implementation of a new ERP system.

Financial income (expenses), net. In the year ended December 31, 2008, we had financial income of approximately $1.3 million, compared to financial income of approximately $6 million in 2007. The decrease in our financial income is mainly attributed to the significant decrease in interest income from held-to-maturity marketable securities of which approximately $4.2 million due to the decrease in interest rates on our reduced cash balance and approximately $0.7 million due to the devaluation of the Company s pension funds of approximately $0.7 million which were affected by the sharp decline in the capital markets.

Expenses related to aborted merger transaction. During the year of 2008, we recorded expenses of approximately $ 2.3 million of external costs related to the aborted merger transaction.

Other Income. During the year 2008, we received a dividend from a company in which we had invested in an amount of approximately $1.2 million, which investment had previously been written off. A substanial portion of this investment was subsequently sold in the fourth quarter of 2008. The total income from this transaction amounted to approximately $1.8 million.

Taxes on income. Taxes on income are dependent upon where our revenues are generated .Taxes on income in 2008 were approximately $1.4 million compared to approximately $1.0 million in 2007. The slight increase in taxes during 2008 was not driven by any particular change in policy or event.

Year Ended December 31, 2007 Compared to Year Ended December 31, 2006

Revenues. Revenues for the year ended December 31, 2007 and 2006 for our three business segments were as follows:

	Year Ended December 31,			Year Ended December 31,	
	2007	2006	Percentage	2007	2006
	U.S. dollars in thousands		change	Percentage of revenues	
GNS					
Equipment	$ 147,665	$ 118,147	25.0%	52.2%	47.5%
Services	23,754	17,861	33.0%	8.4%	7.2%
	$ 171,419	$ 136,008	26.0%	60.6%	54.7%
Spacenet					
Equipment	$ 26,513	$ 24,312	9.1%	9.4%	9.8%
Services	68,857	69,311	(0.7)%	24.4%	27.9%
	$ 95,370	$ 93,623	1.9%	33.8%	37.7%
SRC					
Equipment	$ 268	$ 1,700	(84.2)%	0.1%	0.7%
Services	33,922	37,170	(8.7)%	12.0%	14.9%
	$ 34,190	$ 38,870	(12.0)%	12.1%	15.6%
Intercompany Adjustments					
Equipment	$ 17,649	$ 18,066	(2.3)%	6.2%	7.3%
Services	711	1,725	(58.8)%	0.3%	0.7%
	$ 18,360	$ 19,791	(7.2)%	6.5%	8.0%
Total					
Equipment	$ 156,797	$ 126,093	24.4%	55.5%	50.7%
Services	125,822	122,617	2.6%	44.5%	49.3%
Total	$ 282,619	$ 248,710	13.6%	100.0%	100.0%

Revenues in 2007 increased by 13.6% compared to 2006. The increase in revenues is primarily attributable to increased revenues in GNS reaching $171.4 million in 2007, up approximately 26% from $136.0 million in 2006. This growth derives mainly from projects in Eastern Europe, Africa and India which include turnkey projects to governments and operators fulfilling universal service obligations. Revenues in 2007 were derived 55.5% from equipment and 44.5% from services. In 2006, our revenues were derived 50.7% from equipment and 49.3% from services. The decrease in the service portion of our business is attributable to the $6.4 million reduction of revenues recognized by SRC, relating to the delay in the release of restricted cash from the Compartel projects in Colombia. This was done in order to ensure that accumulated revenues recognized from the projects will not exceed the accumulated amounts released from the trust. This decrease was offset by an increase in service revenues generated by GNS in connection with value added services sold to our customers.

Gross profit. The gross profit of our three business segments for the years ended December 31, 2007 and 2006 was as follows:

	Year Ended December 31,		Year Ended December 31,	
	2007	2006	2007	2006
	U.S. dollars in thousands		Percentage of revenues per segment	
GNS				
Equipment	$ 72,064	$ 55,752	48.8%	47.2%
Services	13,028	8,172	54.8%	45.8%
	85,092	63,924	49.6%	47.0%
Spacenet				
Equipment	$ 3,449	3,218	13.0%	13.2%
Services	11,097	13,132	16.1%	18.9%
	$ 14,546	$ 16,350	15.3%	17.5%
SRC				
Equipment	$ 231	1,555	86.2%	91.5%
Services	2,089	7,222	6.2%	19.4%
	$ 2,320	$ 8,777	6.8%	22.6%
Intercompany Adjustments	113	1,314	0.6%	6.6%
Total Gross Profit	$ 101,845	$ 90,365	36.0%	36.3%

Our gross profit margin remained at approximately 36% for the years ended December 31, 2007 and 2006. Gross profit increased by approximately $11.5 million as a result of the increase in our revenues. GNS gross margin increased from 47.0% in 2006 to 49.6% in 2007, mainly as a result of high margin equipment transactions, approximately $0.5 million of inventory write offs during 2007 compared to approximately $1.2 million in 2006 and increased service revenues which carry higher margins in GNS. The increase in GNS gross margin was offset by a decrease in SRC s gross margins caused by a deferral of revenues in the Compartel Projects in Colombia for which expenses continued to be recorded.

When reported by segment, the results of Spacenet and SRC are presented based upon intercompany transfer prices. The intercompany adjustments line reflects the intercompany profits that were realized in order to adjust the transfer price to our cost.

Research and Development Expenses:

	Year Ended December 31, 2007	2006	Percentage	Year Ended December 31, 2007	2006
	U.S. dollars in thousands		change	Percentage of revenues per segment	
GNS					
Expenses incurred	$ 17,270	$ 15,687	10.1%	10.1%	11.5%

	Year Ended December 31,			Year Ended December 31,	
Less - grants	2,240	2,045	9.5%	1.3%	1.5%
Total GNS	$ 15,030	$ 13,642	10.2%	8.8%	10.0%

Net research and development costs increased by approximately $1.4 million in the year ended December 31, 2007 compared to 2006. The increase was mainly due to increased salary and related expenses caused mainly by the devaluation of the US Dollar against the NIS during 2007 and increased headcount.

Selling and marketing expenses. The selling and marketing expenses of our three business segments for the years ended December 31, 2007 and 2006 were as follows:

	Year Ended December 31, 2007	Year Ended December 31, 2006	Percentage	Year Ended December 31, 2007	Year Ended December 31, 2006
	U.S. dollars in thousands		change	Percentage of revenues per segment	
GNS	$ 27,113	$ 24,984	8.5%	15.8%	18.4%
Spacenet	8,905	9,403	(5.3)%	9.3%	10.0%
SRC	2,264	2,088	8.4%	6.6%	5.4%
Total	$ 38,282	$ 36,475	5.0%	13.5%	14.7%

Selling and marketing expenses increased by approximately $1.7 million in the year ended December 31, 2007, compared to 2006. This increase is attributable mainly to increased expenses in GNS associated with our increased revenues in 2007.

General and administrative expenses. The general and administrative expenses of our three business segments for the year ended December 31, 2007 and 2006 were as follows:

	Year Ended December 31, 2007	Year Ended December 31, 2006	Percentage	Year Ended December 31, 2007	Year Ended December 31, 2006
	U.S. dollars in thousands		change	Percentage of revenues per segment	
GNS	$ 12,135	$ 11,314	7.3%	7.1%	8.3%
Spacenet	12,979	9,528	36.2%	13.6%	10.2%
SRC	5,938	5,958	(0.3)%	17.4%	15.3%
Total	$ 31,052	$ 26,800	15.9%	11.0%	10.8%

General and administrative expenses increased by approximately $4.3 million in 2007, compared to 2006. This increase is attributable primarily to an increase in general and administrative expenses in Spacenet relating to a $1.2 million provision for sales and use tax, an increase in rent expenses of approximately $0.7 million resulting from vacant sublet space for a short period during 2007, increased professional consulting fees of approximately $0.6 million relating to Sarbanes Oxley and tax consultants, $0.5 million relating to franchise and communication taxes and an increase of approximately $0.2 million relating to legal fees. The increased general and administrative expenses in GNS are attributable mainly to the increase in the level of our operations.

Financial income (expenses), net. In the year ended December 31, 2007, we had financial income of approximately $6.0 million, compared to financial expenses of approximately $0.7 million in 2006. The increase in our financial income is mainly attributable to a $3.7 million decrease in interest expenses on long-term loans due to the conversion of the convertible loan from York at the end of September 2006 and an increase of $2.9 million in interest income from bank deposits and held to maturities marketable securities, increased cash balances and an increase in Libor rates.

Taxes on income. Taxes on income in 2007 were approximately $1.0 million compared to approximately $2.4 million in 2006. Taxes on income are dependent upon where our revenues are generated and the reduction in taxes in 2007 is not driven by any particular change in policy or event.

Variability of Quarterly Operating Results

Our revenues and profitability may vary from quarter to quarter and in any given year, depending primarily on the sales mix of our family of products and the mix of the various components of the products (i.e. the volume of sales of remote terminals versus hub equipment and), sale prices, and production costs, as well as entering into new service contracts, the termination of existing service contracts, or different profitability levels between different service contracts. Sales of our products to a customer typically consist of numerous remote terminals and related hub equipment, which carry varying sales prices and margins.

Annual and quarterly fluctuations in our results of operations may be caused by the timing and composition of orders by our customers and the timing of our ability to recognize revenues. Our future results may also be affected by a number of factors, including our ability to continue to develop, introduce and deliver new and enhanced products on a timely basis and expand into new product offerings at competitive prices, to anticipate effectively customer demands and to manage future inventory levels in line with anticipated demand. Our results may also be affected by currency exchange rate fluctuations and economic conditions in the geographical areas in which we operate. In addition, our revenues may vary significantly from quarter to quarter as a result of, among other factors, the timing of new product announcements and releases by our competitors and us. We cannot be certain that revenues, gross profit and net income (or loss) in any particular quarter will not vary from the preceding or comparable quarters. Our expense levels are based, in part, on expectations as to future revenues. If revenues are below expectations, operating results are likely to be adversely affected. In addition, a substantial portion of our expenses are fixed (i.e. space segment, lease payments), and adjusting the expenses in cases where revenues drop unexpectedly often takes considerable time. As a result, we believe that period-to-period comparisons of our results of operations are not necessarily meaningful and should not be relied upon as indications of future performance. Due to all of the foregoing factors, it is possible that in some future quarters our revenues or operating results will be below the expectations of public market analysts or investors. In such event, the market price of our shares would likely be materially adversely affected.

Our business historically has not been affected by seasonal variations.

Liquidity and Capital Resources

Since inception, our financing requirements have been met through cash from funds generated by private equity investments, public offerings, issuances of convertible notes, bank loans, operations, as well as funding from research and development grants. In addition, we also finance our operations through available credit facilities as discussed below. We have used available funds primarily for working capital, capital expenditures and strategic investments.

In July 2005, Bank Hapoalim assigned an outstanding Company loan in the amount of $71.4 million held by it to York Capital Management LP. In December 2005, we revised the terms of the loan that was assigned by Bank Hapoalim to York. Under the amendment, York agreed to defer certain principal payments due and established a new payment schedule. In consideration, we agreed to reduce the exercise price of the warrant issuable to York (assigned by Bank Hapoalim) to $ 6.75 per share for the period ending September 30, 2006. On September 27, 2006, York exercised its right to have us issue it warrants in the amount of the loan and accrued interest and immediately exercised its option to convert the warrants into shares at $6.75 per share. This resulted in our issuance of approximately 10.6 million ordinary shares to York. As a result of the conversion, our liabilities were reduced by approximately $68.1 million, including approximately $1.0 million of accrued interest and net of the approximately $3.3 million of the unamortized balance representing the fair value of change in conversion feature. Our shareholders equity increased by the same amount. No profit or loss was recorded as a result of the conversion.

In December, 2006, we completed a public offering of 8,050,000 of our ordinary shares at a price to the public of $8.50 per share. Of such shares, 5,016,667 ordinary shares were sold by us and the remaining shares were sold by York. We received net proceeds of approximately $39.9 million from the offering.

As of December 31, 2008, we had cash and cash equivalents of $73.9 million, held to maturity marketable securities of $63 million, short-term and long-term restricted cash of $14.3 million, short-term restricted cash held in trustees accounts of $24.2 million and short-term bank credits of $6.5 million. As of December 31, 2007, we had cash and cash equivalents of $122.8 million, short-term bank deposits and held to maturity marketable securities of $45.6 million, short-term and long-term restricted cash of $13.4 million, short-term and long-term restricted cash held in trustees accounts of $24.0 million and short-term bank credits of $5.8 million.

As of December 31, 2008, our accumulated debt was approximately $34.6 million, comprised of long-term loans of $18.3 million and convertible subordinates notes of approximately $16.3 million.

Our credit agreements contain various restrictions and limitations that may impact us, including pledges on our assets and property. These restrictions and limitations relate to incurrence of indebtedness, contingent obligations, liens, mergers and acquisitions, asset sales, dividends and distributions, redemption or repurchase of equity interests, certain debt payments and modifications of loans and investments.

The following table summarizes our cash flows for the periods presented:

	December 31,		
	2008	**2007**	**2006**
		US Dollars in thousands	
Net cash provided by (used in) operating activities	$ (19,620)	$ 22,775	$ 37,824
Net cash provided by (used in) investing activities	(25,507)	(53,836)	8,312
Net cash provided by (used in) financing activities	(2,168)	3,307	28,169
Effect of exchange rate changes on cash and cash equivalents	(1,596)	1,016	311
Net increase (decrease) in cash and cash equivalents	(48,891)	(26,738)	74,616
Cash and cash equivalents at beginning of the period	122,807	149,545	74,929
Cash and cash equivalents at end of the period	$ 73,916	$ 122,807	$ 149,545

Our cash and cash equivalents decreased by approximately $49 million during the year ended December 31, 2008 as a result of the following:

Operating activities. Cash used in operating activities was approximately $19.6 million mainly due to an increase in trade receivables, in a net amount of approximately $16 million and a decrease in other accounts payable and other long-term liabilities, mainly deferred revenue in amount of approximately $16.6 million. The above was offset by an increase in accrued expenses of approximately $3.6 million and positive cash provided by other operating activity in amount of $9.4 million.

Investing activities. Cash used in investing activities was approximately $25.5 million, mainly from net investments in held to maturity marketable securities in the amount of approximately $15.7 million, purchase of property and equipment in the amount of approximately $13.8 million, net investment in restricted cash (including long term) in the amount of approximately $0.9 million, net of proceeds from loans to employees of approximately $2.8 million, proceeds from sale of investments, net in amount of $1.6 million and proceed from the sale of property and equipment in amount of $0.5 million.

Financing activities. Cash used in financing activities was approximately $2.2 million, primarily from the repayment of our long term loan in amount of $5.4 million, net of proceeds of approximately $2.5 million from the exercise of options and approximately $0.7 million from short term bank credit.

Our cash and cash equivalents decreased by $26.7 million during the year ended December 31, 2007 as a result of the following:

Operating activities. Cash provided by operating activities was approximately $22.7 million mainly due to a decrease in other assets (including short-term, long-term and deferred charges) in the amount of $28.5 million and growth in our positive net cash flow provided by other operating activities in the amount of $32.4 million. The above was offset in part by an increase in trade receivables of approximately $14.0 million and a decrease in other accounts payables and other long term liabilities of approximately $24.2 million.

Investing activities. Cash used in investing activities was approximately $53.8 million, mainly from net investment in held to maturity marketable securities in the amount of approximately $43.5 million, purchase of property and equipment in the amount of approximately $9.3 million, net investment in restricted cash (including long term) in the amount of approximately $1.9 million net of proceeds from loans to employees of approximately $0.9 million.

Financing activities. Cash provided by financing activities was approximately $3.3 million, primarily from proceeds of approximately $4.6 million from the exercise of options, net proceeds of approximately $4.6 million of short term bank credit, net of repayment of long term loans of approximately $5.6 and net of approximately $0.3 million of issuance expenses in respect of a public offering completed in December 2006.

Contractual Obligations

As of December 31, 2008, our short and long term obligations were as follows:

Contractual Obligations	Payments due by period (in thousands)				
	Total	2009	2010-2011	2012-2013	2014 and after
Long-term loans *	$ 18,349	$ 4,346	$ 14,003	$ -	$ -
Convertible subordinated notes	16,315	-	1,706	14,609	-
Accrued interest related to restructured debt (including $653 as short term accrued expenses)	2,491	653	1,254	584	-
Capital lease obligations	30	30	-	-	-
Operating lease	88,299	31,009	32,103	13,162	12,025
Other long-term debt	3,973	250	500	500	2,723
Total contractual cash obligations	$ 129,457	$ 36,288	$ 49,566	$ 28,855	$ 14,748

(*) Future interest payments are not included due to variability in interest rates

Off Balance Sheet Arrangements

At times, we guarantee the performance of our work to some of our customers, primarily government entities. Guarantees are often required for our performance during the installation and operational periods of long-term rural telephony projects such as in Latin America, and for the performance of other projects (government and corporate) throughout the rest of the world. The guarantees typically expire when certain operational milestones are met. In addition, from time to time, we provide corporate guarantees to guarantee the performance of our subsidiaries. No guarantees have ever been exercised against us.

As of December 31, 2008, the aggregate amount of bank guarantees outstanding in order to secure our various performance obligations was approximately $14.7 million, comprised of performance guarantees provided on behalf of our subsidiaries, including an aggregate of approximately $6.3 million on behalf of our subsidiary in Peru. We have restricted cash as collateral for these guarantees in an amount of approximately $1.9 million.

In addition, in connection with the agreements with the Ministry of Communications in Colombia, we have provided back to back corporate guarantees for performance guarantees and employee salary and benefit guarantees issued on our behalf by local Colombian insurance companies in an aggregate amount of $32 million.

We have also provided bank guarantees mainly for certain leases for our offices worldwide, which are secured by restricted cash in the amount of approximately $5.8 million.

Impact of Inflation and Currency Fluctuations

While most of our sales and service contracts are in U.S. dollars and most of our expenses are in U.S. dollars and NIS, portions of our projects in Latin America are linked to their respective local currencies. The foreign exchange risks are often significant due to fluctuations in local currencies relative to the U.S. dollar.

The influence on the U.S. dollar cost of our operations in Israel relates primarily to the cost of salaries in Israel, which are paid in NIS and constitute a substantial portion of our expenses in NIS. In 2008, there was inflation in Israel of 3.8% and the U.S Dollar depreciated in relation to the NIS at a rate of 1.1%, from NIS 3.846 per $1 on December 31, 2007 to NIS 3.802 per $1 on December 31, 2008. In the period ending in December 31, 2007 inflation in Israel was 3.4% while the U.S. dollar depreciated in relation to the NIS at a rate of 9.0%. If future inflation in Israel exceeds the devaluation of the NIS against the U.S. dollar or if the timing of such devaluation lags behind increases in inflation in Israel, our results of operations may be materially adversely affected. In 2008 and 2009, in order to limit these risks, we entered into hedging agreements to cover certain of our NIS to US Dollar exchange rate exposures.

Regarding the changes in the value of other foreign currencies in relation to the U.S. dollar, our monetary balances that are not linked to the U.S. dollar impacted our financial expenses during 2008 and 2007. This is due to heavy fluctuations in currencies in certain regions of Latin America in which we do business. There can be no assurance that in the future our results of operations may not be materially adversely affected by other currency fluctuations.

Effective Corporate Tax Rate

On January 1, 2003, a comprehensive tax reform took effect in Israel. Pursuant to the tax reform, resident companies are subject to Israeli tax on income accrued or derived in Israel or abroad. In addition, the concept of a controlled foreign corporation was introduced, according to which an Israeli company may become subject to Israeli taxes on certain income of a non-Israeli subsidiary if the subsidiary s primary source of income is passive income (such as interest, dividends, royalties, rental income or capital gains). The tax reform also substantially changed the system of taxation of capital gains. Following the reform, the capital gains tax rate applicable to us was decreased from 36% to 25%, while the allocation of the gain between the two periods is proportional to the holding periods until December 31, 2002, and after December 31, 2002. In 2007 and in 2008, this tax reform did not have any material effect on our liquidity, financial condition or results of operations.

Israeli companies are subject to income tax on their worldwide income. Pursuant to tax reform legislation that came into effect in 2003, the corporate tax rate is to undergo staged reductions to 25% by the year 2010. In order to implement these reductions, the corporate tax rate is scheduled to decline from 27% in 2008 to 26% in 2009 and 25% in 2010. However, the effective tax rate payable by a company that derives income from an Approved Enterprise, discussed further below, may be considerably less.

On April 1, 2005, an amendment to the Investment Law came into effect which significantly changed the provisions of the Investment Law. The Amendment limits the scope of enterprises which may be approved by the Investment Center by setting criteria for the approval of a facility, such as provisions generally requiring that at least 25% of the approved enterprise s income will be derived from export. A facility that is approved under the Amendment is called a Benefited Enterprise. Additionally, the Amendment enacted major changes in the manner in which tax benefits are awarded under the Investment Law so that companies no longer require Investment Center approval in order to qualify for tax benefits. However, the Investment Law provides that terms and benefits included in any certificate of approval already granted will remain subject to the provisions of the law as in effect on the date of such approval. Therefore, our existing Approved Enterprises will not be subject to the provisions of the Amendment.

According to the Amendment, tax-exempt income generated under the provisions of the Amendment will be subject to taxes upon distribution or liquidation and we may be required in the future to record deferred tax liabilities with respect to such tax-exempt income. As of December 31, 2008, we did not generate income under the provisions of the Amendment.

Currently, we have nine Approved Enterprise programs under the alternative route of the Investment Law. The period of benefits for all of these programs has expired. See ITEM 10: Additional Information Israeli Taxation. In addition, our company chose 2005 as the year of election for a new Benefited Enterprise under the amendment.

We expect to derive a substantial portion of our operating income, when we become profitable for Israeli tax purposes from future Benefited Enterprise facilities. We may therefore be eligible for a tax exemption for a limited period on undistributed Benefited Enterprise income, and an additional subsequent period of reduced corporate tax rates ranging between 10% and 25%, depending on the level of foreign ownership of our shares, on undistributed such Benefited Enterprise income. Income from sources other than the Approved Enterprises or Benefited Enterprises during the relevant period of benefits will be taxable at the regular corporate tax rates.

We anticipate that we will not have to pay taxes relating to the 2009 tax year for most of our major entities due to current or carry forward tax losses. Cash outlays for income taxes in the future might be different from tax expenses, mainly due to cash tax payments for previous years that might be triggered by tax audits in the various tax jurisdictions, deferred tax expenses (income) and payments usually made in arrears for annual taxes in profitable years.

Research and Development

We devote significant resources to research and development projects designed to enhance our VSAT products, to expand the applications for which they can be used and to develop new products. We intend to continue to devote research and development resources to complete development of certain features, to improve functionality, including supporting higher throughput, to improve space segment utilization, and to reduce the cost of our products.

We devoted significant research and development resources in 2008, 2007 and 2006 to the development of our SkyEdge family of products. We develop our own network software and software for our VSATs. We generally license our software to customers as an incidental part of the sale of our network products and services. We also license certain third party software for use in our products.

Our software and our internally developed hardware are proprietary and we have implemented protective measures both of a legal and practical nature. We have obtained and registered patents in the United States and in various other countries in which we offer our products and services. We rely upon the copyright laws to protect against unauthorized copying of the object code of our software and upon copyright and trade secret laws for the protection of the source code of our software. We derive additional protection for our software by licensing only the object code to customers and keeping the source code confidential. In addition, we enter into confidentiality agreements with our customers and other business partners to protect our software technology and trade secrets. We have also made copyright, trademark and service mark registrations in the United States and abroad for additional protection of our intellectual property. Despite all of these measures, it is possible that competitors could copy certain aspects of our technology or obtain information that we regard as a trade secret in violation of our legal rights.

Third-Party Funding

In accordance with an agreement entered in 2001 with the Chief Scientist we are eligible to participate in a program under which we are eligible to receive future research and development grants for generic research and development projects without any royalty repayment obligations.

The following table sets forth, for the years indicated, our gross research and development expenditures, the portion of such expenditures which was funded by royalty-bearing and non-royalty bearing grants and the net cost of our research and development activities:

	Years		
	2008	2007	2006
	(U.S. dollars in thousands)		
Gross research and development costs	$ 18,702	$ 17,270	$ 15,687
Less:			
Non-royalty-bearing grants	1,760	2,240	2,045
Research and development costs - net	$ 16,942	$ 15,030	$ 13,642

Trend Information

We estimate that the current worldwide recession will have an adverse affect on our sales in 2009. Specifically, we are experiencing longer sales cycles in the emerging markets and we see more conservative spending in the telecom sector.

In the past few years the satellite communications market has experienced increasing competition both from within its sector and from competing satellite communication technologies. Specifically, the expansion of cellular coverage in rural areas worldwide, increased terrestrial infrastructures as well as the advancement of wireless technologies, increases the options for our potential and existing customers. In addition, the number of satellite communications providers in the market has increased and prices of technologies continue to decline. Another development in our industry is the increasing demand for complete solutions which encompass far more than a single platform of a communications solution.

We estimate that the political environment in Israel could continue to prevent certain countries from doing business with us and this, in addition to the increased competition and reduced prices in the telecommunications industry overall, may have adverse effects on our business. Given all of the above, we cannot guarantee or predict what our sales will be, what trends will develop and if any changes in our business and marketing strategy will be implemented.

Impact of Recently Issued Accounting Pronouncements

In February 2008, the FASB issued FASB Staff Position (FSP) FAS No. 157-2, Effective Date of FASB Statement No. 157 (FSP 157-2), to delay the effective date of FASB Statement 157 for one year for certain nonfinancial assets and nonfinancial liabilities, excluding those that are recognized or disclosed in financial statements at fair value on a recurring basis (that is, at least annually). For purposes of applying the FSP 157-2, nonfinancial assets and nonfinancial liabilities include all assets and liabilities other than those meeting the definition of a financial asset or a financial liability in FASB Statement 159. FSP 157-2 defers the effective date of Statement 157 to fiscal years beginning after November 15, 2008, and interim periods within those fiscal years for items within the scope of this FSP 157-2. We do not expect the adoption of FSP 157-2 will have a material impact on our financial position, results of operations or cash flows.

In March 2008, the FASB issued Statement 161 Disclosures about Derivative Instruments and Hedging Activities (SFAS 161) an amendment to FASB No. 133. This statement changes the disclosure requirements for derivative instruments and hedging activities. Entities are required to provide enhanced disclosures about (a) how and why an entity uses derivative instruments, (b) how derivative instruments and related hedged items are accounted for under Statement 133 and its related interpretations, and (c) how derivative instruments and related hedged items affect an entity s financial position, financial performance, and cash flows. This statement is effective for financial statements issued for fiscal years and interim periods beginning after November 15, 2008. We do not expect the adoption of SFAS 161 will have a material impact on our financial position, results of operations or cash flows.

In December 2007, the FASB issued SFAS 160, Noncontrolling Interests in Consolidated Financial Statements (SFAS 160). SFAS 160 amends ARB 51, Consolidated Financial Statements , to establish accounting and reporting standards for the noncontrolling interest in a subsidiary and for the deconsolidation of a subsidiary. It also clarifies that a noncontrolling interest in a subsidiary is an ownership interest in the consolidated entity that should be reported as equity in the consolidated financial statements. SFAS 160 also changes the way the consolidated income statement is presented by requiring consolidated net income to be reported at amounts that include the amounts attributable to both the parent and the noncontrolling interest. It also requires disclosure, on the face of the consolidated statement of income, of the amounts of consolidated net income attributable to the parent and to the noncontrolling interest. SFAS 160 requires that a parent recognize a gain or loss in net income when a subsidiary is deconsolidated and requires expanded disclosures in the consolidated financial statements that clearly identify and distinguish between the interests of the parent owners and the interests of the noncontrolling owners of a subsidiary. SFAS 160 is effective for fiscal periods, and interim periods within those fiscal years, beginning on or after December 15, 2008. The impact of SFAS 160 on our consolidated financial statements will depend on the nature and size of acquisitions, if any, subsequent to the effective date.

In December 2007, the FASB issued SFAS 141(R), Business Combinations (SFAS 141(R)). This Statement replaces SFAS No. 141, Business Combinations , and requires an acquirer to recognize the assets acquired, the liabilities assumed, including those arising from contractual contingencies, any contingent consideration and any noncontrolling interest in the acquiree at the acquisition date, measured at their fair values as of that date, with limited exceptions specified in the statement. SFAS 141(R) also requires the acquirer in a business combination achieved in stages (sometimes referred to as a step acquisition) to recognize the identifiable assets and liabilities, as well as the noncontrolling interest in the acquiree, at the full amounts of their fair values (or other amounts determined in accordance with SFAS 141(R)). In addition, SFAS 141(R) s requirement to measure the noncontrolling interest in the acquiree at fair value will result in recognizing the goodwill attributable to the noncontrolling interest in addition to that attributable to the acquirer. SFAS 141(R) applies prospectively to business combinations for which the acquisition date is on or after the beginning of the first annual reporting period beginning on or after December 15, 2008. The impact of SFAS 141R on our consolidated results of operations and financial condition will depend on the nature and size of acquisitions, if any, subsequent to the effective date.

In April 2008, the FASB issued FSP 142-3, Determination of the Useful Life of Intangible Assets (FSP 142-3). FSP 142-3 amends the factors that should be considered in developing renewal or extension assumptions used to determine the useful life of a recognized intangible asset under SFAS No. 142, Goodwill and Other Intangible Assets . FSP 142-3 is effective for fiscal years beginning after December 15, 2008. We are currently evaluating the potential impact, if any, of the adoption of FAS 142-3 on our consolidated financial statements.

EITF Issue No. 08-7, Defensive Intangible Assets (EITF 08-7), requires an acquiring entity to account for defensive intangible assets as a separate unit of accounting. Defensive intangible assets should not be included as part of the cost of the acquirer s existing intangible assets because the defensive intangible assets are separately identifiable. Defensive intangible assets must be recognized at fair value in accordance with SFAS 141(R) and SFAS 157. EITF 08-7 will be effective for the reporting period beginning after December 15, 2008. The impact of EITF 08-7 on our company s consolidated financial statements will depend on the nature and size of acquisitions, if any, subsequent to the effective date

In May 2008, the FASB issued SFAS No. 162, The Hierarchy of Generally Accepted Accounting Principles . SFAS 162 identifies the sources of accounting principles and the framework for selecting the principles to be used in the preparation of financial statements of nongovernmental entities that are presented in conformity with generally accepted accounting principles in the United States. It is effective 60 days following the SEC s approval of the Public Company Accounting Oversight Board amendments to AU Section 411, The Meaning of Present Fairly in Conformity With Generally Accepted Accounting Principles . We do not expect SFAS No. 162 to have a material effect on our financial statements.

In October 29, 2008, the FASB issued FSP No.132 (R)-a, Employers Disclosures about Pensions and Other Postretirement Benefits, to require that an employer disclose the following information about the fair value of plan assets: 1) the level within the fair value hierarchy in which fair value measurements of plan assets fall; 2) information about the inputs and valuation techniques used to measure the fair value of plan assets; and 3) a reconciliation of beginning and ending balances for fair value measurements of plan assets using significant unobservable inputs. The FSP will be effective for fiscal years ending after December 15, 2009, with early application permitted. Application of the FSP would not be required for earlier periods that are presented for comparative purposes. We are currently evaluating the potential impact of adopting this FSP on the disclosures in our financial statements.

In June 2008, the FASB issued FSP EITF No. 03-6-1 Determining Whether Instruments Granted in Stock-based Payment Transactions Are Participating Securities . Under the FSP, unvested stock-based payment awards that contain rights to receive non-forfeitable dividends (whether paid or unpaid) are participating securities, and should be included in the two-class method of computing EPS. The FSP is effective for fiscal years beginning after December 15, 2008, and interim periods within those years. We are currently evaluating the impact of EITF 03-6-1 on our financial statements.

ITEM 6: DIRECTORS AND SENIOR MANAGEMENT

Directors

The following table sets forth the name, age, position(s) and a brief account of the business experience of each of the directors:

Name	Age	Position(s)
Amiram Levinberg	53	Chairman of the Board of Directors and Chief Executive Officer
Haim Benjamini(1)(2)	69	External Director
Jeremy Blank	30	Director
Ehud Ganani	56	Director
Leora Meridor(1)(2)	61	External Director
Karen Sarid(1)(2)	58	Director
Izhak Tamir(1)(2)	56	Director

(1) Member of our Compensation and Stock Option Committee.

(2) Member of our Audit Committee.

Amiram Levinberg co-founded our company and served as a director on our board since its inception and until April 2004. In July 2005, Mr. Levinberg rejoined our company as our Chairman of the Board and Chief Executive Officer. From July 1995 and until April 15, 2003, he served as our President. Until 2002, Mr. Levinberg also served as our Chief Operations Officer. Until July 1995, he served as our Vice President of Engineering. From 1977 to 1987, Mr. Levinberg served in a research and development unit of the Israel Defense Forces, where he managed a large research and development project. He was awarded the Israel Defense Award in 1988. Mr. Levinberg holds a B.Sc. in Electrical Engineering and Electronics and a M.Sc. degree in Digital Communications from Israel Institute of Technology, in Haifa, Israel, or the Technion. Mr. Levinberg serves on the board of directors of Orckit Communications Ltd., a company traded on the NASDAQ Global, Cardboard Industries and Kargal, a cardboard manufacturer in Israel.

Haim Benjamini has served on our board as an external director since February 2005. Mr. Benjamini currently serves as an advisor to Teva Pharmaceutical Industries Ltd. s CEO, board and management. He served as the Corporate Vice President of Human Resources of Teva from 1988 until December 31, 2004. From 1982 to 1988, Mr. Benjamini served as the Corporate Vice President of Human Resources at Scitex Corporation. Mr. Benjamini served as a guest lecturer at Tel Aviv University from 1997 to 2003 as part of the Masters of Arts program in Labor Studies. Mr. Benjamini holds a M.A. (Organizational Behavior) from the University of Chicago and a B.A (Social Sciences, Sociology and Political Science) from the Hebrew University. Mr. Benjamini is a Brigadier General (Ret) in the Israel Defense Forces and served in various command staff and training roles from 1957 until 1982.

Jeremy Blank has served on our board since July 2005.. Mr. Blank is a managing director of York Capital Management. Previously, Mr. Blank served as a Vice President within York. York is a private investment fund headquartered in New York with approximately $10 billion in assets under management. From 1999 to 2004, Mr. Blank worked at Morgan Stanley as a vice president within Morgan Stanley s fixed income department and earlier, in Morgan Stanley s mergers and acquisitions department. Mr. Blank graduated from Yeshiva University in New York City with a Bachelor s degree in Finance.

Dr. Ehud Ganani has served on our board since July 2005. Dr. Ganani currently serves as Chairman of the boards of directors of TraceGuard Technologies Inc.. TraceGuard is involved in Explosive Detection equipment for airports and other security facilities. Mr. Ganani served as the chief executive officer of the company between 2006-2008. Dr. Ganani is also the chief executive officer and president of Rabintex Industries Ltd.. Rabintex deals with personal protection gear and army vehicles modifications. Dr. Ganani is the chairman of the board of Bird Aerosystems Ltd., a private company that develops and supplies anti missiles protection systems for helicopters and fixed wing military and civilian aircrafts. He is the chairman of the public committee for Aerospace & Defense & HLS in the Israeli Export Institute..Dr. Ganani served as the Chief Executive Officer of Israel Military Industries from 2002-2005. Prior to that he served in various senior positions in Rafael Armament Development Authority, the last of which was as Vice President of Marketing and Business Development from 1997-2002. Dr. Ganani headed the rocket motors development group in Rafael between 1986 to 2001. He also served as a visiting professor of Chemical Engineering at UC Davis, CA (1984-1985). Dr. Ganani holds a Doctorate of Science in chemical engineering from Washington University, St. Louis, MO (1984) and a Bachelor of Science in Chemical Engineering from the Technion.

Dr. Leora (Rubin) Meridor has served on our board since August 2005. Dr. Meridor is a business and financial consultant and serves on the board of Teva Pharmaceutical Industries Ltd., Osem Investment Ltd., Alrov (Israel) Ltd. and Delta Galil Industries Ltd. Between 2001 and 2004, Dr. Meridor served as chair of the board of Poalim Capital Markets Ltd. and between 2001 and 2005, as chair of the boards of directors of Bezeq International Ltd. and Walla! Communications Ltd. Between 1996 and 2000 she served as Senior Vice President, Head of Credit & Risk Management Division of the First International Bank. From 1992 to 1996 she served as Head of Research at the Bank of Israel. Dr. Meridor has a Ph.D in Economics, an M.Sc in Mathematics and B.Sc. in Mathematics and Physics, all from the Hebrew University in Jerusalem. Her studies include a post doctoral year at Massachusetts Institute of Technology.

Karen Sarid has served on our board since July 2005. Ms. Sarid currently serves as the chief operating officer and chief financial officer of Galil Medical Ltd. and as the general manager of Galil Israel. Galil Medical is a medical device company that develops a cryotherapy platform. Ms. Sarid has served as a General Manager of Orex Computed Radiography Ltd., a Carestream company focusing on advanced radiography systems for the digital x-ray market since September 2000 until March 2007. From September 1999 until September 2000, Ms. Sarid served as Chief Financial Officer and a member of the board of directors of Forsoft Ltd., a software solutions provider and a subsidiary of the Formula Group. From 1996 until August 1999, Ms. Sarid was Chief Financial Officer and a member of the board of directors of ESC Medical Systems Ltd., a medical laser manufacturer that is traded on the NASDAQ Stock Market. Ms. Sarid was Chief Financial Officer of EZchip Semiconductors Ltd. (previously LanOptics Ltd.) from 1993 through 1996. Ms. Sarid currently serves on the board of directors of EZchip. Ms Sarid also serves on the board of directors of Oridion Ltd. Ms. Sarid received a B.A. in Economics and Accounting from Haifa University, and was awarded the CFO of the Year award in 1998 by the Association of Chief Financial Officers in Israel.

Izhak Tamir has served on our board since July 2005. Mr. Tamir, a co-founder of Orckit Communications Ltd., has been President and a Director of Orckit since its founding in 1990and currently serves as Chairman of the Board of such company. Orckit traded on the NASDAQ Global, is a leading provider of advanced telecom equipment targeting high capacity packetized broadband services. Mr. Tamir served on the board of directors of Scopus Video Networks from 2005 until 2007. From 1987 until 1989, Mr. Tamir was employed by Comstream Inc., in San Diego, California. From 1985 until 1987, he was Vice President of A.T. Communication Channels Ltd., a subsidiary of Bezeq. From 1978 to 1985, he was a senior engineer in the Israeli government. Mr. Tamir holds an engineering degree from the Technion, and an M.B.A. from Tel Aviv University. Mr. Tamir has served as Chairman of the board of directors of Tikcro Technologies Ltd. since January 2000 and as its Chief Executive Officer from August 2003 until December 2007.

Senior Management

The executive officers and key executives of our company and its subsidiaries are as follows:

Name	Age	Position(s)
Amiram Levinberg(1)	53	Chief Executive Officer and Chairman of the Board of Directors
Erez Antebi	49	Chief Executive Officer, Gilat Networks Systems, and President, Spacenet Rural Communications
Andreas Georghiou	59	Chief Executive Officer, Spacenet Inc.
Joshua Levinberg	55	Executive Vice President, Corporate Business Development & Strategy
Ari Krashin	36	Chief Financial Officer

(1) Please see biography under Directors above.

Erez Antebi was appointed as Chief Executive Officer of Gilat Networks Systems on June 1, 2005, and as CEO of Spacenet Rural Communications on February 1, 2008. Mr. Antebi served as our Chief Operating Officer from October 2002 until September 2003, when he left to serve as Chief Executive Officer of Clariton Networks Ltd. From the beginning of 1998 until being appointed our Chief Operating Officer, Mr. Antebi served as our Vice President, General Manager for Asia, Africa and Pacific Rim. From September 1994 until the beginning of 1998, he served as Vice President and General Manager of Gilat Inc. Mr. Antebi joined our company in May 1991 as product manager for the Skystar Advantage VSAT product. From August 1993 until August 1994, he served as Vice President of Engineering and Program Management of Gilat Inc. Prior to joining us, Mr. Antebi worked for a private importing business from 1989 to 1991, after having served from 1987 to 1989 as marketing manager for high frequency radio communications for Tadiran Limited, a defense electronics and telecommunications company, and as a radar systems development engineer at Rafael, the research and development and manufacturing arm of the Israel Defense Forces, from 1981 to 1987. Mr. Antebi holds a B.Sc. and an M.Sc. Electrical Engineering from the Technion.

Andreas Georghiou joined Spacenet Inc. as its Chief Executive Officer in August 2006. Prior to joining Spacenet, Mr. Georghiou had been with SES Americom and its predecessor, GE Americom, a unit of GE Capital, for over 20 years in various leadership roles. Immediately preceding his assumption of CEO duties at Spacenet, Mr. Georghiou served as Chief Commercial Officer at SES Americom and, prior to that and through July 2005 he served as the Senior Vice President of Business Operations. From 2003 through July 2006, Mr. Georghiou also served as President of Americom Asia Pacific, a regional satellite venture of SES. From 1994 to 2003 he served as the Senior Vice President of Sales & Marketing for Global Satellite Services at GE Americom. From 1992 to 1994 he served as Americom s Director of Business Development. While at GE Americom, he also served as an officer of GE Capital. In addition, Mr. Georghiou held various positions at RCA Corporation including IT Manager, Director of Treasury Planning and Manager of Operations Research, at the David Sarnoff Research Center. He is a member of the Board of Directors of Society of Satellite Professionals International (SSPI) and a member of the Corporate Leadership Advisory Council of the U.S. Chamber of Commerce. Mr. Georghiou holds an undergraduate degree from the University of Pennsylvania, and a master s degree from the Wharton School of Business, where he studied as a Fulbright Scholar.

Joshua Levinberg, a co-founder of Gilat, rejoined our company as Executive Vice President of Corporate Business Development & Strategy in August 2005 .[. From June 1999 until 2003, he served as Senior Vice President for Business Development of our company, having previously served in that position from 1994 to April 1998. At that time, Mr. Levinberg became Chief Executive Officer of GTH LA Antilles, then the parent company of Global Village Telecom, or GVT, until June 1999. From 1989 until September 1994, he served as Executive Vice President and General Manager of Gilat Satellite Networks, Inc. in the U.S. From 1987 until the formation of Gilat Satellite Networks, Inc. in 1989, Mr. Levinberg was Vice President of Marketing & Business Development of our company. Mr. Levinberg holds a B.Sc. (Electrical Engineering and Electronics) from Tel Aviv University. Amiram Levinberg and Joshua Levinberg are brothers.

Ari Krashin was appointed our Chief Financial Officer in June 2008. Mr. Krashin joined our company in April 2000 and served in various positions in our company since then. From 2005 to June 2008 Mr. Krashin served as our Financial Director. Before joining us, Mr. Krashin served as a CPA for Kesselman & Kesselman, PriceWaterhouseCooper s Israel office. Mr. Krashin is a CPA and holds a BA in Business Administration and Accounting from the College of Management.

Compensation of Directors and Officers

The following table sets forth the aggregate compensation paid to or accrued on behalf of all of our directors and officers as a group for the year ended December 31, 2008:

	Salaries, Fees, Directors' Fees, Commissions and Bonuses(1)	Pension, Retirement and Similar Benefits
All directors and officers as a group (19 persons)	$ 4,530,457	$ 520,984

(1) Also includes bonuses and stock option compensation accrued in 2008.

Management Agreements

Mr. Amiram Levinberg, our Chairman and Chief Executive Officer has an employment agreement with us which was extended by the shareholders in a general meeting held in May, 2008, for an additional one year period, and will terminate July 2009. Under Mr. Levinberg s employment agreement which was extended in May 2008, Mr. Levinberg was granted (i) options to purchase 915,000 ordinary shares at an exercise price of $5.77 per share and is entitled to (ii) a salary of 100,000 NIS per month; (iii) a transaction bonus equal to 0.82% of the market value of our company in a transaction or series of related transactions following which a company, person or a group of persons or companies acting together will purchase from our company s shareholders, in a bona fide, arms length transaction, 50% or more of our then outstanding share capital subject to Mr. Levinberg complying with certain prior conditions; and (iv) entitlement to participate in our company s annual bonus plan, subject to the specific approval of the shareholders. In addition, at our shareholders meeting held on December 30, 2008 Mr. Levinberg was granted the right to purchase 300,000 ordinary shares of our company at a purchase price of $4.00 per share, which vest ratably, each quarter over a three year period.

Prior to the closing of the transaction pursuant to which Bank Hapoalim assigned its loan to our company to York Capital Management, York, paid $100,000 to a company controlled by Mr. Amiram Levinberg and his brother, Mr. Joshua Levinberg, to perform due diligence on our company. In addition, Mr. Amiram Levinberg had a right to certain benefits from options held by York in shares of our company owned by Bank Hapoalim. For further information on Mr. Levinberg s relationship with York, please see the Major Shareholders table and the footnote on York.

As of December 31, 2008, Mr. Yoav Leibovitch, formerly the Executive Vice President of Corporate Development, is no longer an officer of the Company.

Board Compensation

By resolutions adopted by our shareholders, directors who are not employees (excluding the current chairman of the board of directors) are entitled to receive annual compensation of NIS 80,000 and an additional NIS 1,600 for each board or committee meeting attended, provided that the board member is a member of such committee. In addition, board members are compensated for telephone participation in board and committee meetings in an amount of 60% of what would be received for physical attendance. All the above amounts are subject to adjustment for changes in the Israeli consumer price index after December 2007 and changes in the amounts payable pursuant to Israeli law from time to time. Each of our current directors was granted options to purchase 20,000 ordinary shares upon commencement of his or her terms as director and at an exercise price equal to the fair market value of the shares on the date of the grant. In addition, in our December 30, 2008 annual general meeting of the shareholders, our shareholders approved a one-time grant to purchase 50,000 shares, which options vest ratably, each quarter, over a three-year period. The exercise price of the options is $4.00 per share.

Board Composition and Practices

Our Articles of Association as adopted at a shareholders meeting on April 15, 2003and amended at our shareholders meeting on December 30, 2008, provide that our board of directors shall consist of not less than five and not more than nine directors as shall be determined from time to time by a majority vote at the general meeting of our shareholders. Unless resolved otherwise by our shareholders, our board of directors will be comprised of (i) nine directors, if four directors are appointed by beneficial owners of 14% or more of our issued and outstanding ordinary shares (as set forth below), or (ii) seven directors, if fewer than four directors are so appointed by beneficial owners of 14% or more of our ordinary shares.

Pursuant to our Articles of Association, each beneficial owner of 14% or more of our issued and outstanding ordinary shares is entitled to appoint, at each annual general meeting of our shareholders, one member to our board of directors, provided that a total of not more than four directors are so appointed. In the event that more than four qualifying beneficial owners notify us that they desire to appoint a member to our board of directors, only the four shareholders beneficially owning the greatest number of shares shall each be entitled to appoint a member to our board of directors. So long as our ordinary shares are listed for trading on NASDAQ, we may require that any such appointed director qualify as an independent director as provided for in the NASDAQ rules then in effect. Our board of directors has the right to remove any such appointed director when the beneficial ownership of the shareholder who appointed such director falls below 14% of our ordinary shares.

Our Articles of Association provide that a majority of the voting power at the annual general meeting of our shareholders will elect the remaining members of the board of directors, including external directors as required under the Companies Law. At any annual general meeting at which directors are appointed pursuant to the preceding paragraph, the calculation of the vote of any beneficial owner who appointed a director pursuant to the preceding paragraph shall not take into consideration, for the purpose of electing the remaining directors, ordinary shares constituting 14% of our issued and outstanding ordinary shares held by such appointing beneficial owner.

Each of our directors (except external directors) serve, subject to early resignation or vacation of office in certain circumstances as set forth in our Articles of Association, until the adjournment of the next annual general meeting of our shareholders next following the general meeting in which such director was elected. The holders of a majority of the voting power represented at a general meeting of our shareholders in person or by proxy will be entitled to (i) remove any director(s), other than external directors and directors appointed by beneficial holders of 14% or more of our issued and outstanding ordinary shares as set forth above, (ii) elect directors instead of directors so removed, or (iii) fill any vacancy, however created, in the board of directors. Our board of directors may also appoint additional directors, whether to fill a vacancy or to expand the board of directors, who will serve until the next general meeting of our shareholders following such appointment.

Our Articles of Association further provide that the board of directors may delegate all of its powers to committees of the board of directors as it deems appropriate, subject to the provisions of applicable law.

Alternate Directors

Our Articles of Association provide that a director may appoint, by written notice to us and subject to the consent of the board of directors, any person qualified to serve as a director to serve as an alternate director (provided such person does not already serve as a director or an alternate director). An external director may not be appointed as an alternate director, unless otherwise permitted in the Companies Law. An alternate director shall have all of the rights and obligations of the director appointing him or her, except the power to appoint an alternate (unless otherwise specifically provided for in the appointment of such alternate). An alternate director may not act at any meeting at which the director appointing him or her is present and he is not entitled to remuneration. Unless the time period or scope of any such appointment is limited by the appointing director, such appointment is effective for all purposes and for an indefinite time, but will expire upon the expiration of term or vacation of office of the appointing director. Currently, no alternate directors have been appointed.

External Directors

Under the Companies Law, public companies are required to elect two external directors who must meet specified standards of independence. Companies that are registered under the laws of Israel and whose shares are listed for trading on a stock exchange outside of Israel, such as Our company, are treated as public companies with respect to the external directors requirement. External directors may not have during the two years preceding their appointment, directly or indirectly through a relative, partner, employer or controlled entity, any affiliation with (i) the public company, (ii) those of its shareholders who are controlling shareholders at the time of appointment, or (iii) any entity controlled by the company or by its controlling shareholders. The term affiliation includes an employment relationship, a business or professional relationship maintained on a regular basis, control and services as an office holder. No person can serve as an external director if the person s other positions or business creates or may create conflicts of interest with the person s responsibilities as an external director. Until the lapse of two years from termination of office, a company may not engage an external director as an employee or otherwise.

External directors serve for a three-year term, which may be renewed for only one additional three-year term. External directors can be removed from office only by the court or by the same special percentage of shareholders that can elect them, and then only if the external directors cease to meet the statutory qualifications with respect to their appointment or if they violate their fiduciary duty to the company. The court may additionally remove external directors from office if they were convicted of certain offenses by a non-Israeli court or are permanently unable to fulfill their position. If, when an external director is elected, all members of the board of directors of a company are of one gender, the external director to be elected must be of the other gender.

If delegated any authority of the board of directors, any committee of the board of directors must include at least one external director. An external director is entitled to compensation as provided in regulations adopted under the Companies Law and is otherwise prohibited from receiving any other compensation, directly or indirectly, in connection with such service.

The Companies Law requires external directors to submit to the company, prior to the date of the notice of the general meeting convened to elect the external directors, a declaration stating their compliance with the requirements imposed by Companies Law for the office of external director. External Directors are required to have professional ability or financial and accounting expertise, as long as at least one of the External Directors is a financial and accounting expert.

The election of external directors requires the affirmative vote of a majority of our ordinary shares voted on in person or by proxy at a meeting of the shareholders, provided that such majority includes at least one-third of the votes of the non-controlling shareholders of the company who are voting on this matter at the meeting. This approval requirement need not be met if the aggregate shareholdings of those non-controlling shareholders who vote against the election of the external directors represent one percent or less of all the voting power of the company. Controlling for the purpose of this provision means the ability to direct the acts of the company. Any person holding one half or more of the voting power of the company or of the right to appoint directors or the chief executive officer is presumed to have control of the company.

We currently have two external directors: Dr. Leora Meridor, who was elected at the Special General Meeting held on August 30, 2005 and reelected at our Annual General Meeting held on December 30, 2008 for an additional three year period; and Mr. Haim Benjamini who was elected at the Special General Meeting held in February 2005and reelected for an additional three year period at our company s Special General Meeting held on May 28, 2008.

Audit Committee

The Companies Law provides that publicly traded companies must appoint an audit committee. The responsibilities of the audit committee include identifying irregularities in the management of the company s business and approving related party transactions as required by law. An audit committee must consist of at least three members, and include all of the company s external directors. However, the chairman of the board of directors, any director employed by the company or providing services to the company on a regular basis, any controlling shareholder and any relative of a controlling shareholder may not be a member of the audit committee. An audit committee may not approve an action or a transaction with an officer or director, a transaction in which an officer or director has a personal interest, a transaction with a controlling shareholder and certain other transactions specified in the Companies Law, unless at the time of approval two external directors are serving as members of the audit committee and at least one of the external directors was present at the meeting in which an approval was granted.

In addition, the NASDAQ Marketplace Rules require us to establish an audit committee comprised of at least three members, all of whom must be independent directors, each of whom is financially literate and satisfies the respective independence requirements of the Securities and Exchange Commission and NASDAQ and one of whom has accounting or related financial management expertise at senior levels within a company.

Our audit committee assists our Board of Directors in overseeing the accounting and financial reporting processes of our company and audits of our financial statements, including the integrity of our financial statements, compliance with legal and regulatory requirements, our independent registered public accountants qualifications and independence, the performance of our internal audit function and independent registered public accountants, finding any defects in the business management of our company and proposing to our Board of Directors ways to correct such defects, approving related-party transactions as required by Israeli law, and such other duties as may be directed by our Board of Directors. The audit committee may consult from time to time with our independent auditors and internal auditor with respect to matters involving financial reporting and internal accounting controls.

Our audit committee consists of four members of our Board of Directors who satisfy the respective independence requirements of the Securities and Exchange Commission, NASDAQ and Israeli law for audit committee members. Our audit committee consists of Mr. Benjamini, Dr. Meridor, Dr. Sarid and Mr. Tamir. Our board of directors has determined that Dr. Meridor qualifies to serve as the audit committee s financial expert, as required by the SEC and NASDAQ. The audit committee meets at least once each quarter.

Our board of directors adopted an audit committee charter setting forth the responsibilities of the audit committee consistent with the rules of the Securities and Exchange Commission and the NASDAQ Marketplace Rules which include:

Oversight of the company s independent registered public accounting firm, and recommending the engagement, compensation or termination of the company s independent registered public accounting firm to the board of directors, subject to shareholder ratification in accordance with Israeli law;

Recommending the terms of audit and non-audit services provided by the independent registered public accounting firm for pre-approval by the board of directors;

Recommending the engagement or termination of office of the company's internal auditor; and

Approval of transactions with office holders, controlling shareholders and other related-party transactions, as described below.

Under the Israeli Companies Law, the approval of the audit committee is required for specified actions and transactions with office holders and controlling shareholders. For such purpose, the term controlling shareholder is a shareholder who has the power to direct the company s operations, other than by virtue of being a director or other office holder of the company and includes a shareholder that holds 50% or more of the voting rights in a public company, or a shareholder who has the power to direct the conduct of the company, if the company has no shareholder that owns more than 50% of its voting rights, then the term also includes any shareholder that holds 25% or more of the voting rights of the company (two or more persons who have a personal interest in the approval of the transaction are deemed to be joint holders). The audit committee may not approve an action or a transaction with a controlling shareholder or with an office holder unless at the time of approval the two outside directors are serving as members of the audit committee and at least one of them was present at the meeting at which the approval was granted.

Additionally, under the Israeli Companies Law, the role of the audit committee is to identify faults in the business practices of the company, among other things, by consulting with the company s independent registered public accounting firm and internal auditor, and to make recommendations to the board for remedying such faults.

Independent Directors

Pursuant to the current listing requirements of the NASDAQ Global Market, we are required to have at least a majority of our directors on our board of directors qualify as independent. Effective March 3, 2005, NASDAQ revised the rules so that a foreign private issuer (such as our company) may follow home country practice in lieu of complying with this rule.

Based on representations from our current directors, we believe that all of our directors except Mr. Levinberg comply with the independence standards set forth above.

Employees

As of December 31, 2008, we had approximately 966 full-time employees, including 163 employees in engineering, research and development, 426 employees in manufacturing, operations and technical support, 137 employees in marketing and sales, 140 employees in administration and finance and 100 in other departments. Of these employees, 397 employees were based in our facilities in Israel, 233 were employed in the United States, 288 were employed in Latin America and 48 in Asia, the Far East and other parts of the world. We also utilize temporary employees, as necessary, to supplement our manufacturing and other capabilities. We believe that our relations with our employees are satisfactory. We and our employees are not parties to any collective bargaining agreements. However, certain provisions of the collective bargaining agreements between the Histadrut (General Federation of Labor in Israel) and the Coordination Bureau of Economic Organizations (including the Manufacturers Association of Israel) are applicable to all Israeli employees by order of the Israeli Ministry of Labor and Welfare. These provisions principally concern the length of the work day and the work week, minimum wages for workers, contributions to a pension fund, insurance for work-related accidents, procedures for dismissing employees, determination of severance pay and other conditions of employment. The amount and frequency of these adjustments are modified from time to time.

As of December 31, 2007, we had approximately 970 full-time employees, including 156 employees in engineering, research and development, 412 employees in manufacturing, operations and technical support, 147 employees in marketing and sales, 146 employees in administration and finance and 105 in other departments. Of these employees, 392 employees were based in our facilities in Israel, 228 were employed in the United States, 288 were employed in Latin America and 58 in Asia, the Far East and other parts of the world. We also utilize temporary employees, as necessary, to supplement our manufacturing and other capabilities. We believe that our relations with our employees are satisfactory.

As of December 31, 2006, we had approximately 950 full-time employees, including 160 employees in engineering, research and development, 400 employees in manufacturing, operations and technical support, 130 employees in marketing and sales, 140 employees in administration and finance and 120 in other departments. Of these employees, 400 employees were based in our facilities in Israel, 235 were employed in the United States, 250 were employed in Latin America and 65 in Asia, the Far East and other parts of the world.

Israeli law generally requires severance pay upon the retirement or death of an employee or termination of employment without due cause. Our ongoing severance obligations are partially funded by making quarterly payments to approved severance funds or insurance policies, with the remainder accrued as a long-term liability in our consolidated financial statements. In addition, Israeli employees and employers are required to pay specified to the National Insurance Institute, which is similar to the U.S. Social Security Administration. Since January 1, 1995, such amounts also include payments for national health insurance. The payments to the National Insurance Institute are approximately 16.31% of wages (up to a specified amount), of which the employee contributes approximately 64% and the employer contributes approximately 36%. The majority of our permanent employees are covered by life and pension insurance policies providing customary benefits to employees, including retirement and severance benefits. For Israeli employees, we contribute 13.33% to 15.83% (depending on the employee) of base wages to such plans and the permanent employees contribute 5% of base wages.

During April and May 2008 we amended the contracts of most of our Israeli employees so that starting on the date of the amended agreement, such employees are subject to Section 14 of the Severance Pay Law 1963 for severance pay accumulated in periods of employment subsequent to date of the amendment. In accordance with this Section 14, upon termination, the release of the contributed amounts from the fund to the employee shall relieve us of any further severance liability, and no additional payments shall be due to the employee.

We have a number of savings plans in the United States that qualify under Section 401(k) of the U.S. Internal Revenue Code. We contribute one dollar for each dollar a participant contributes in this plan, in an amount of up to 3% of a participant s earnings and in addition, we contribute fifty cents for each dollar a participant voluntarily contributes in this plan, up to an additional 3% of a participant s earnings. Matching contributions in 2008, 2007 and 2006 for all the plans were approximately $ 0.7 million per year. Matching contributions are invested in proportion to each participant s voluntary contributions in the investment options provided under the plan.

Share Ownership

See table under Item 7: Major Shareholders and Related Party Transactions below.

Stock Option Plans

In June 1995, we adopted the 1995 Stock Option Plan (Incentive and Restricted Stock Options), or the 1995 ISO/RSO Plan, the 1995 Section 102 Stock Option/Stock Purchase Plan, or the 1995 Section 102 Plan, and the 1995 Advisory Board Stock Option Plan, or the 1995 Advisory Board Plan. The 1995 Plans expired on June 29, 2005.

As of December 31, 2008, we had granted options to purchase a total of 101,580 ordinary shares under the 1995 Plans and options to purchase 59,467 ordinary shares remain outstanding. The exercise prices for such options vary from $9.2 to $2,730 and all such options expire at various times from January 2009 to September 2012. As of December 31, 2008, a total of 42,113 options have been exercised under the 1995 Plan.

In September 2003, we adopted the 2003 Stock Option Plan (Incentive and Restricted Stock Options), or the 2003 ISO/RSO Plan and the Section 102 Stock Option Plan 2003, or the 2003 Section 102 Plan and collectively, the 2003 Plans . In February 2005, our shareholders increased the pool for the 2003 Plans by 1,135,000 shares and in December 2005, our shareholders further increased the pool by 3,500,000 shares, such that the 2003 Plans provide for the granting of options of up to an aggregate of 6,135,000 ordinary shares to our officers, directors, employees or service providers or any of the employees or service providers of our subsidiaries. As of December 31, 2008, options to purchase a total of 3,584,157 ordinary shares under the 2003 Plans were outstanding, and options to purchase 1,852,080 ordinary shares have been exercised. The exercise prices for such options vary from $5.00 to $10.73 and such options expire at various times from August 2013 to November 2017.

In December 2005, our shareholders adopted the 2005 Stock Incentive Plan with a pool of 1.5 million shares. This plan is designed to enable the board of directors to determine various forms of incentives for all forms of service providers and, when necessary, adopt a Sub-plan in order to grant specific incentives. In October 2008, the compensation/stock option committee of the Board of Directors adopted a sub-plan so as to enable qualified optionees certain tax benefits under the Israeli Income Tax Ordinance. Among the incentives that may be adopted are share options, performance share awards, performance share unit awards, restricted shares, restricted share unit awards and other share based awards. Also, in October 2008 the compensation/stock option committee adopted a new plan, the 2008 Stock Incentive Plan, with a pool of 1 million shares and a sub-plan to enable qualified optionees certain tax benefits under the Israeli Income Tax Ordinance. In November 2008, the compensation/stock option committee of the Board of Directors authorized the grant of restricted stock units under the 2005 and 2008 Plans to certain key employees. The entitlement to these shares vest quarterly over a four-year period (15%, 25%, 30%, 30% each year, respectively) so long as the employee remains with our company. In December 2008, our shareholders authorized the grant of 600,000 options to the members of our board of directors. Those options vest quarterly over three years. To date, we have granted 650,000 options and an additional 1,505,000 restricted share units under the 2005 and 2008 Plans, 55,064 of which have already been issued.

As of March 1, 2008**,** the 11 directors and executive officers listed above, as a group, held options to purchase 2,805,225 of our ordinary shares at a weighted average exercise price of $5.49 per share. Out of such options, 225 options expire in 2011, 130,000 options expire in 2013, 600,000 options expire in 2014 and 2,075,000 options expire in 2015. As of March 1, 2008, the 11 and executive officers listed above, as a group, held 346,500 RSUs and 11,700 shares received through vested RSUs.

The purpose of the 2003, 2005 and 2008 plans (together the Plans) is to enable us to attract and retain qualified persons as employees, officers, directors, consultants and advisors and to motivate such persons by providing them with an equity participation in our company. The Section 102 Plans are designed to afford qualified optionees certain tax benefits under the Israel Income Tax Ordinance.

The Plans are administered by the Compensation/Stock Option Committee appointed by our board of directors. The Stock Option Committee, comprised of Dr. Meridor, Mr. Benjamini, Mr. Tamir and Dr. Sarid, has broad discretion, subject to certain limitations, to determine the persons entitled to receive options, the terms and conditions on which options or rights to purchase are granted and the number of shares subject thereto. The Stock Option Committee also has discretion to determine the nature of the consideration to be paid upon the exercise of an option and/or right to purchase granted under the Plans. Such consideration generally may consist of cash or, at the discretion of the Board, cash and a recourse promissory note.

Stock options issued as incentive stock options pursuant to the Plans will only be granted to the employees (including directors and officers) of our company or its subsidiaries. The exercise price of incentive stock options issued pursuant to the ISO/RSO Plan must be at least equal to the fair market value of the ordinary shares as of the date of the grant (and, in the case of optionees who own more than 10% of the voting stock, the exercise price must equal at least 110% of the fair market value of the ordinary shares as of the date of the grant).

Options are exercisable and restrictions on disposition of shares lapse according to the terms of the individual agreements under which such options were granted or shares issued.

ITEM 7: MAJOR SHAREHOLDERS AND RELATED PARTY TRANSACTIONS

A. Major Shareholders

The following table sets forth certain information with respect to the beneficial ownership of our ordinary shares as of March 31, 2009 (including options exercisable and RSU s vested within 60 days of March 31, 2009) with respect to: (i) each person who is believed by us to be the beneficial owner of more than 5% of the ordinary shares; (ii) each director or officer who holds more than 1% of the ordinary shares, and (iii) all directors and officers as a group. Except where otherwise indicated, we believe, based on information furnished by the owners, that the beneficial owners of the ordinary shares listed below have sole investment and voting power with respect to such shares, subject to any applicable community property laws. The shareholders listed below do not have any different voting rights from any other shareholders of our company, except to the extent that they hold more than 14% and as such, they will have a right to appoint a director, subject to certain conditions in our Articles of Association. None of the directors, officers or key executives listed in the Directors and Senior Management table appearing in Item 6 above, owns 1% or more of our outstanding share capital.

The information in this table is based on 40,103,662ordinary shares outstanding as of March 31, 2009. Except where otherwise indicated, we believe, based on information furnished by the owners, that the beneficial owners of the ordinary shares listed below have sole investment and voting power with respect to such shares, subject to any applicable community property laws.

Name and Address	Number of Ordinary Shares Beneficially Owned	Percent of Ordinary Shares Outstanding
York Capital Management [1]	8,070,563	20.1%
Mivtach Shamir Finance Ltd. [2]	2,216,945	5.5%
Renaissance Technologies LLC [3]	2,163,894	5.4%
Migdal Insurance & Financial Holdings Ltd.[4]	2,003,812	5.0%
All officers and directors as a group (11 persons)[5]	2,333,468	36.00%

(1) Based on a Schedule 13D filed on December 20, 2006, the shares are directly owned by or allocated for the benefit of (i) York Capital Management, L.P., a Delaware limited partnership; (ii) York Investment Limited, a corporation established in the Commonwealth of the Bahamas; and (iii) York Credit Opportunities Fund, L.P., a Delaware limited partnership. These three entities are part of a family of pooled investment vehicles managed by JGD Management Corp., a Delaware corporation doing business as York Capital Management. The sole shareholder of JGD is James G. Dinan. Dinan Management is the general partner of York Capital Management L.P. and James G. Dinan and Daniel A. Schwartz are the controlling members of Dinan Management. York Offshore Limited is the investment manager of York Investment Limited. The controlling principal of York Offshore Limited is James G. Dinan. Daniel A. Schwartz is a director of York Offshore Limited. York Credit Opportunities Domestic Holdings is the general partner of York Credit Opportunities. James G. Dinan and Daniel A. Schwartz are the controlling members of York Credit Opportunities Domestic Holdings. The principal business address of each of these entities and individuals is c/o York Capital Management, 767 Fifth Avenue, 17th Floor, New York, New York, 10153.

(2) Based on a Schedule 13D filed on July 28, 2005. Mr. Meir Shamir and Ashtrom Industries Ltd. share voting and dispositive power with respect to the shares held by Mivtach Shamir Holdings Ltd. The address of Mivtach Shamir Holdings Ltd. is Beit Sharvat, 4 Kaufman St., Tel Aviv 68012, Israel.

(3) Based on a Schedule 13G filed on February 13, 2009, Renaissance Technologies LLC and Mr. James H. Simons share ownership with respect to the shares held by Renaissance Technologies LLC because of Dr. Simons position as control person of Renaissance Technologies LLC. The address of Renaissance Technologies LLC is 800 Third Avenue, New York, New York.

(4) Based on a Schedule 13G filed on February 9, 2009, The 2,003,812 shares reported in the Schedule as beneficially owned by the Migdal Insurance & Financial Holdings Ltd. are held for members of the public through, among others, provident funds, mutual funds, pension funds and insurance policies, which are managed by subsidiaries of Reporting Person, according to the following segmentation: 1,028,327 shares are held by Profit participating life assurance accounts; 895,868 Ordinary Shares are held by Provident funds and companies that manage provident funds and 79,617 shares are held by companies for the management of funds for joint investments in trusteeship, each of which subsidiaries operates under independent management and makes independent voting and investment decisions. The address of Migdal Insurance & Financial Holdings Ltd is 4 Efal Street; P.O. Box 3063; Petach Tikva, 49512, Israel.

(5) Includes options that are currently exercisable or are exercisable within 60 days that are held by our directors and executive officers.

Significant Changes in the Ownership of Major Shareholders

As of December 31, 2006, our major shareholders were York, holding 8,070,563 shares (approximately 20% ownership), Bank Hapoalim, holding 2,052,428 shares (approximately 5% ownership) and Mivtach Shamir Finance Ltd., holding 2,216,945 shares (approximately 6 % ownership). As of December 31, 2007, our major shareholders were York, holding 8,070,563 shares (approximately 20% ownership), Citadel Investment Group, L.L.C., holding 2,140,424 shares approximately 5 % ownership) and Mivtach Shamir Finance Ltd., holding 2,216,945 shares (approximately 5 % ownership). As of December 31, 2008, our major shareholders were York, holding 8,070,563 shares (approximately 20% ownership), and Mivtach Shamir Finance Ltd., holding 2,216,945 shares (approximately 5 % ownership).

Major Shareholders Voting Rights

The voting rights of our major shareholders do not differ from the voting rights of other holders of our ordinary shares.

Record Holders

Based on a review of the information provided to us by our transfer agent, as of April 1**,** 2009, there were 83 holders of record of our ordinary shares, of which 65 record holders holding approximately 95.5% of our ordinary shares had registered addresses in the United States and 11 record holders holding approximately 4.5% of our ordinary shares had registered addresses in Israel. These numbers are not representative of the number of beneficial holders of our shares nor is it representative of where such beneficial holders reside since many of these ordinary shares were held of record by brokers or other nominees, including CEDE & Co., the nominee for the Depositary Company (the central depositary for the U.S. brokerage community), which held approximately 75% of our outstanding ordinary shares as of said date.

B. Related Party Transactions.

In July 2005, Bank Hapoalim assigned a $71.4 million loan owed by our company to the bank, to York Capital Management. In December 2005, we revised the terms of this loan. On September 27, 2006, York exercised its right to have our company issue it warrants in the amount of the loan and accrued interest and immediately exercised its option to convert the warrants into shares at $6.75 per share. This resulted in the issuance of approximately 10.6 million ordinary shares to York. In December 2006, York participated as a selling shareholder in our public offering and sold 3,033,333 ordinary shares. Please see Item 5: Liquidity and Capital Resources Financing Activities.

C. Interests of Experts and Counsel.

Not applicable.

ITEM 8: FINANCIAL INFORMATION

Consolidated Statements

See the consolidated financial statements, including the notes thereto, and the exhibits listed in Item 18 hereof and incorporated herein by this reference.

Export Sales

We outsource a majority of our manufacturing, some from Israel and some from outside of Israel. For information on our revenues breakdown for the past three years, see Item 5: Operating and Financial Review and Prospects.

Legal Proceedings

We are a party to various legal proceedings incident to our business. Except as noted below, there are no material legal proceedings pending or, to our knowledge, threatened against us or our subsidiaries, and we are not involved in any legal proceedings that our management believes, individually or in the aggregate, would have a material adverse effect on our business, financial condition or operating results.

On March 31, 2008 we announced the signing of a Merger Agreement pursuant to which we would be acquired for an aggregate value of $ 475 million in an all cash transaction by a consortium of private equity investors. On August 5, 2008 we informed the consortium that all conditions precedent to closing has been met. On August 29, 2008 we notified the consortium we were terminating the Merger Agreement citing the consortium members intentional breach of the Merger Agreement and their failure to close the merger transaction within the extended period established to complete the transaction. In November 2008, we filed lawsuits against each of the parties that had guaranteed the payment of a termination fee under the Merger Agreement. The lawsuits were filed in the Tel Aviv District Court against each of Mivtach Shamir Holdings Ltd., LR Group Ltd., Gores Capital Partners II, L.P, and DGB Investments, Inc. for their pro rata commitment to guarantee the termination fee due to the Company. The Merger Agreement provides for a termination fee in the amount of $47.5 million, payable to us, in the event of an intentional breach of the agreement by the Buyer.

In October 2008, a lawsuit and a motion for its approval as a class action proceeding was filed in the District Court of Jerusalem by eight individuals and Israeli companies against us, all of our directors and our 20% shareholder, York Capital Management. The plaintiffs claim damages based on the amounts they would have been paid had the merger with the consortium closed. We and our outside legal counsel believe the claims are completely without merit, and that the lawsuit is without basis. We intend to use all legal means necessary to protect and defend our company and its directors.

In September 2003, Nova Mobilcom S.A., or Mobilcom, filed a lawsuit against Gilat do Brasil for specific performance of a Memorandum of Understanding which provided for the sale of Gilat do Brasil, and specifically the GESAC project, a government education project awarded to Gilat do Brazil, to Mobilcom for an unspecified amount. Gilat do Brasil does not believe that this claim has any merit and is vigorously defending itself against the claims presented therein.

The Brazilian tax authority has filed a claim against a subsidiary of Spacenet Inc. in Brazil, for alleged taxes due of approximately $4 million. In January 2004, the subsidiary received notice of an administrative ruling reducing the amount of the claim, and the subsidiary filed an appeal of such ruling. In December 2005, this appeal was denied and at present, the subsidiary faces a tax liability of approximately $6.7 million (the amount has increased due to interest and exchange rate differences). The subsidiary denies such claims and has filed a petition known as a Ação Anulatória in the State Courts of the State of São Paulo, Brazil.

From time to time, we are notified of claims that we may be infringing patents, copyrights or other intellectual property rights owned by third parties. While we do not believe we are currently infringing any intellectual property rights of third parties, we cannot assure that other companies will not, in the future, pursue claims against us with respect to the alleged infringement of patents, copyrights or other intellectual property rights owned by third parties. In addition, litigation may be necessary to protect our intellectual property rights and trade secrets, to determine the validity of and scope of the propriety rights of others or to defend against third-party claims of invalidity. Any litigation could result in substantial costs and diversion of resources and could have a material adverse effect on our business, financial condition and operating results.

If any claims or actions are asserted against us, we may seek to obtain a license under a third party s intellectual property rights. We cannot assure, however, that a license will be available under terms that are acceptable to us, if at all. The failure to obtain a license under a patent or intellectual property right from a third party for technology used by us could cause us to incur substantial liabilities and to suspend the manufacture of the product covered by the patent or intellectual property right. In addition, we may be required to redesign our products to eliminate infringement if a license is not available. Such redesign, if possible, could result in substantial delays in marketing of products and in significant costs. In addition, should we decide to litigate such claims, such litigation could be extremely expensive and time consuming and could materially adversely affect our business, financial condition and operating results, regardless of the outcome of the litigation.

We are also a party to various regulatory proceedings incident to our business. To the knowledge of our management, none of such proceedings is material to us or to our subsidiaries.

Dividend Policy

We have never paid cash dividends on our ordinary shares and cannot anticipate paying any cash dividends in the foreseeable future. We have decided to reinvest permanently the amount of tax-exempt income derived from our Approved Enterprises and not to distribute such income as dividends. See notes 9 and 12 of the notes to consolidated financial statements included in this annual report on Form 20-F. We may only pay cash dividends in any fiscal year out of profits, as determined under Israeli law. In addition, the terms of some of our financing arrangements restrict us from paying dividends to our shareholders.

In the event we declare dividends in the future, we will pay those dividends in NIS. Because exchange rates between NIS and the dollar fluctuate continuously, a U.S. shareholder will be subject to currency fluctuation between the date when the dividends are declared and the date the dividends are paid.

Significant Changes

Except as otherwise disclosed in this annual report, no significant change has occurred since December 31, 2008.

ITEM 9: THE OFFER AND LISTING

A. Offer and Listing Details

Annual Stock Information

The following table sets forth, for the periods indicated, the range of high and low closing sale price for the ordinary shares, as reported by NASDAQ.

	Price		Average Daily Trading Volume
	High	Low	
Year Ended December 31, 2004:	$ 9.40	$ 4.00	219,488
Year Ended December 31, 2005:	$ 7.48	$ 5.19	88,311
Year Ended December 31, 2006:			
First Quarter	$ 6.44	$ 5.59	61,384
Second Quarter	$ 8.37	$ 5.96	82,938
Third Quarter	$ 9.54	$ 7.15	77,997
Fourth Quarter	$ 10.01	$ 8.37	142,675
Year Ended December 31, 2007:			
First Quarter	$ 9.74	$ 7.89	161,902
Second Quarter	$ 9.87	$ 8.07	172,138
Third Quarter	$ 10.25	$ 8.40	163,679
Fourth Quarter	$ 11.18	$ 10.01	118,200
Year Ended December 31, 2008:			
First Quarter	$ 11.05	$ 9.46	164,233
Second Quarter	$ 11.00	$ 10.52	210,527
Third Quarter	$ 11.15	$ 5.45	327,327
Fourth Quarter	$ 5.79	$ 2.20	174,669
Most Recent Six Months:			
October 2008	$ 5.79	$ 3.07	191,083
November 2008	$ 3.76	$ 2.41	168,947
December 2008	$ 2.75	$ 2.2	162,450
January 2009	$ 3.17	$ 2.69	141,040
February 2009	$ 3.79	$ 3.12	153,921
March 2009	$ 3.60	$ 2.86	50,468
April 2009 (through April 6)	$ 3.58	$ 3.50	34,650

B. Plan of Distribution

Not applicable.

C. Markets

Our ordinary shares are quoted on the NASDAQ Global Market under the symbol GILT and are listed on the Tel Aviv Stock Exchange.

D. Selling Shareholders

Not applicable.

E. Dilution

Not applicable.

F. Expense of the Issue

Not applicable.

ITEM 10: ADDITIONAL INFORMATION

A. Share Capital

Not applicable.

B. Memorandum and Articles of Association

Set out below is a description of certain provisions of our Articles of Association and of the Israeli Companies Law related to such provisions. This description is only a summary and does not purport to be complete and is qualified by reference to the full text of the Articles of Association, which are incorporated by reference as exhibits to this annual report, and to Israeli law.

Registration and Purposes

We are an Israeli company registered with the Israel companies register, registration No. 52-003893-6.

Under the Companies Law, a company may define its purposes as to engage in any lawful business and may broaden the scope of its purposes to the grant of reasonable donations for any proper charitable cause, even if the basis for any such donation is not dependent upon business considerations. Article 3A of our Articles of Association provides that our purpose is to engage in any business permitted by law and that we can also grant reasonable donations for any proper charitable cause.

Amendment of the Articles of Association

Under the Companies Law, a company may amend its articles of association by the affirmative vote of a majority of the shares voting and present at the general meeting of shareholders or by a different voting if so provided by the company s articles of association. Article 3 of our Articles of Association provides that the Articles of Association may be amended by a resolution approved by holders of a majority of the shares represented at a general meeting and voting on such resolution, if such amendment is recommended by the board of directors; in any other case, by a resolution approved by holders of at least 75% of the shares represented at a general meeting and voting on such resolution.

Israeli law further provides that any amendment to the articles of association of a company that obligates a shareholder to acquire additional shares or to increase the extent of his liability shall not obligate the shareholder without his prior consent.

Amendment of the Memorandum

Companies that were incorporated prior to the effective date of the Companies Law, such as our company, may amend their memorandum of association to authorize future amendments to the memorandum of association by any required voting. On November 9, 2000, our shareholders approved an amendment to our Memorandum of Association, by adding a provision that authorizes our company to amend its Memorandum of Association by the affirmative vote of a majority of the ordinary shares present and voting at the meeting.

Record Date for Notices of General Meeting and Other Action

Under the Companies Law, for the purpose of a shareholder vote, the record date for companies traded outside of Israel, such as our company, can be set between four and twenty-one days before the date of the meeting (see section 182(b)). Article 20 of our Articles of Association provides that the board of directors may set in advance a record date, which shall not be more than forty nor less than four days before the date of such meeting (or any longer or shorter period permitted by law).

Notice of General Meetings; Omission to Give Notice

The Companies Law provides that a company whose shares are traded on an exchange must give notice of a general meeting to its shareholders of record at least twenty-one days prior to the meeting, unless the company s articles provide that a notice need not be sent. Accordingly, Article 25(a) of our Articles of Association provides that not less than 21 days prior notice shall be given to shareholders of record of every General Meeting (i.e. Annual General Meetings and Special General Meetings). It further provides that notice of a General Meeting shall be given in accordance with any law and otherwise as the board of directors may determine. In addition, Article 25(c) of our Articles of Association provides that no shareholder present, in person or by proxy, at the commencement of a General Meeting shall be entitled to seek the revocation of any proceedings or resolutions adopted at such General Meeting on grounds of any defect in the notice of such meeting relating to the time or the place thereof.

Annual General Meetings and Special General Meetings

Under the Companies Law, an annual meeting of the shareholders should be held once in every calendar year and not more than fifteen months from the last annual meeting. The Israeli Companies Law provides that a special meeting of shareholders must be called by the board of directors upon the written request of (i) two directors, (ii) one-fourth of the serving directors, (iii) one or more shareholders who hold(s) at least five percent of the issued share capital and at least one percent of the voting power of the company, or (iv) one or more shareholders who have at least five percent of the voting power of the company. Within twenty one days of receipt of such demand, the board of directors is required to convene the special meeting for a time not later than thirty five days after notice has been given to the shareholders. Article 24 of our Articles of Association provide that our board of directors may call a special meeting of the shareholders at any time and shall be obligated to call a special meeting as specified above.

Quorum at General Meetings

Under Article 26(b) of our Articles of Association, the required quorum for any general meeting of shareholders and for any class meeting is two or more shareholders present in person or by proxy and holding at least twenty five percent (25%) of the issued shares (or of the issued shares of such class in the event of a class meeting). The required quorum in a meeting that was adjourned because a quorum was not present, shall be two shareholders present in person or by proxy. Under Article 26(c) of our Articles of Association, if the original meeting was called as a special meeting, the quorum in the adjourned meeting shall be one or more shareholders, present in person or by proxy and holding the number of shares required to call such a meeting.

Adoption of Resolutions at General Meetings

Article 28(b) of our Articles of Association provides for voting by a written ballot only. In addition, Article 28(c), in accordance with the Companies Law, provides that the declaration of the Chairman of the Meeting as to the results of a vote is not considered to be conclusive, but rather prima facie evidence of the fact. Under our Articles of Association, any resolution of the shareholders, except a resolution for a voluntary liquidation of the company and, in certain circumstances, a resolution to amend our Articles of Association, shall be deemed adopted if approved by the vote of the holders of a majority of the voting power represented at such meeting in person or by proxy.

Voting Power

Article 31 of our Articles of Association provides that every shareholder shall have one vote for each share held by him of record or, in accordance with the definition of shareholder in the Companies Law, in his name with an exchange member and held of record by a nominee company , as such terms are defined in the Companies Law.

We do not have cumulative voting provisions for the election of directors or for any other matter.

Election and Removal of Directors

Under our Articles, the ordinary shares do not have cumulative voting rights in the election of directors. A director is not required to retire at a certain age and need not be a shareholder of our company. Under the Companies Law, a person cannot serve as a director if convicted of certain offenses or been declared bankrupt.

Under our Articles of Association, our board of directors shall consist of not less than five and not more than nine directors as shall be determined from time to time by a majority vote at the general meeting of our shareholders. Unless resolved otherwise, our board of directors is be comprised of nine directors, if four directors are appointed by beneficial owners of fourteen percent or more of our issued and outstanding ordinary shares as set forth below, or seven directors, if fewer than four directors are appointed by beneficial owners of fourteen percent or more of our issued and outstanding ordinary shares as set forth below.

Our Articles further provide that each beneficial owner of fourteen percent or more of our issued and outstanding ordinary shares shall be entitled to appoint, at each annual general meeting of our shareholders, one member to our board of directors (an Appointed Director), provided that a total of not more than four Appointed Directors are so appointed. In the event more than four such qualifying beneficial owners notify us that they desire to appoint an Appointed Director, only the four shareholders beneficially owning the greatest number of shares shall each be entitled to appoint an Appointed Director.

For the purposes of the preceding paragraph, a beneficial owner of ordinary shares means any person or entity who, directly or indirectly, has the power to vote, or to direct the voting of, such ordinary shares. All ordinary shares beneficially owned by a person or entity, regardless of the form which such beneficial ownership takes, shall be aggregated in calculating the number of ordinary shares beneficially owned by such person or entity. All persons and entities that are affiliates (as defined below) of each other shall be deemed to be one person or entity for the purposes of this definition. For the purposes of the preceding paragraph, an affiliate means, with respect to any person or entity, any other person or entity controlling, controlled by, or under common control with such person or entity. Control shall have the meaning ascribed to it in the Israeli Securities Law 1968, i.e. the ability to direct the acts of a company. Any person holding one half or more of the voting power of a company of the right to appoint directors or to appoint the chief executive officer is presumed to have control of the company.

The Articles further stipulate that as a condition to the appointment of an Appointed Director, any appointing shareholder that delivers to our company a letter of appointment shall, prior to such delivery, be required to file with the SEC a Schedule 13D, or an amendment to its Schedule 13D if there is any change in the facts set forth in its Schedule 13D already on file with the SEC which discloses any such change in its holdings of ordinary shares, regardless of whether any filing or amendment is required to be filed under the rules of the Securities Exchange Act of 1934, as amended, and the rules and regulations promulgated thereunder. In addition, any Appointing Shareholder shall be obligated to notify us in writing of any sale, transfer, assignment or other disposition of any kind of ordinary shares by such appointing shareholder that results in the reduction of its beneficial ownership to below the percentage indicated above, immediately after the occurrence of such disposition of shares but in any event not later than the earliest of (i) ten (10) days thereafter, or (ii) the next Annual General Meeting. Without derogating from the foregoing, so long as an Appointed Director serves on the board of directors, the appointing shareholder which appointed such Appointed Director shall provide us, upon our written request at any time and from time to time, with reasonable evidence of its beneficial ownership in the our company.

Under our Articles of Association, so long as our ordinary shares are listed for trading on NASDAQ, we may require that any Appointed Director qualify as an independent director as provided for in the NASDAQ rules then in effect. In addition, in no event may a person become an Appointed Director unless such person does not, at the time of appointment, and did not, within two years prior thereto, engage, directly or indirectly, in any activity which competes with us, whether as a director, officer, employee, contractor, consultant, partner or otherwise.

Under our Articles of Association, the annual general meeting of our shareholders, by the vote of the holders of a majority of the voting power represented at such meeting in person or by proxy, will elect the remaining members of the board of directors. At any annual general meeting at which Appointed Directors are appointed as set forth above, the calculation of the vote of any beneficial owner who appointed a director pursuant to the preceding paragraph shall not take into consideration, for the purpose of electing the remaining directors, ordinary shares constituting fourteen percent of our issued and outstanding ordinary shares held by such appointing beneficial owner.

Appointed Directors, as set forth above, may be removed by our board of directors when the beneficial ownership of the shareholder who appointed such Appointed Director falls below fourteen percent of our ordinary shares. In addition, the office of an Appointed Director will expire upon the removal of the Appointed Director by the shareholder who appointed such Appointed Director or when the Appointed Director ceases to qualify as an independent director as set forth above.

Article 39 of our Articles of Association further provides that the affirmative vote of a majority of the shares then represented at a general meeting of shareholders shall be entitled to remove director(s) other than Appointed Directors from office (unless pursuant to circumstances or events prescribed under the Companies Law), to elect directors instead of directors so removed or to fill any vacancy, however created, in the board of directors. Subject to the foregoing and to early resignation or ipso facto termination of office as provided in Article 42 of our Articles of Association, each director shall serve until the adjournment of the of the Annual General Meeting next following the Annual General Meeting or General Meeting at which such director was elected.

Our directors may, at any time and from time to time, appoint a director to temporarily fill a vacancy on the board of directors or in addition to their body (subject to the number of directors in the board of directors as set forth above), except that if the number of directors then in office constitutes less than a majority of the number provided for entire board of directors, as set forth above, they may only act in an emergency, or to fill the vacancy up to the minimum number required to effect corporate action or in order to call a general meeting for the purpose of electing directors.

Alternate Directors

See Item 6: Directors and Senior Management Alternate Directors .

External Directors

See Item 6: Directors and Senior Management External Directors .

Qualification of Directors

Article 40 of our Articles of Association provides that no person shall be disqualified to serve as a director by reason of him not holding shares in our company or by reason of him having served as director in the past. Our directors are not subject under the Companies Law or our Articles of Association to an age limit requirement. Under the Companies Law, a person cannot serve as a director if he has been convicted of certain offenses, unless specifically authorized by the court, or has been declared bankrupt.

Proceedings of the Board of Directors

Article 46 of our Articles of Association provides that the board of directors may meet and adjourn its meetings and otherwise regulate such meetings and proceedings as the directors think fit. Any director may convene a meeting of the board of directors, upon notice of not less than 7 days.

Consistent with the Companies Law, Article 46 of our Articles of Association provides that no director present at the commencement of a meeting of the board of directors shall be entitled to seek the revocation of any proceedings or resolutions adopted at such meeting on account of any defect in the notice of such meeting relating to the time or the place thereof.

Article 47 of our Articles of Association provides that unless unanimously decided otherwise by the board of directors, a majority of the directors then in office shall constitute a quorum for meetings of the board of directors. No business shall be transacted at a meeting of the board of directors unless the requisite quorum is present.

Our board of directors may elect directors as a Chairman and a Co-Chairman. The Companies Law provides that the Chairman of the board of a company shall have a casting vote in the event of a tied vote, unless the company s articles of association provides otherwise. Article 48 of our Articles of Association provides that neither the Chairman nor the Co-Chairman of the board shall have a casting or additional vote.

Borrowing Powers

The Companies Law authorizes the board of directors of a company, among other things, to determine the credit limit of the company and to issue bonds. Article 35(b) of our Articles of Association states that our board of directors may, from time to time, at its discretion, cause us to borrow or secure the payment of any sum or sums of money, and may secure or provide for the repayment of such sum or sums in such manner, at such times and upon such terms and conditions as it deems fit.

Powers of Chief Executive Officer

The Companies Law provides that transactions between a company and its office holders , which are not extraordinary transactions (as both terms are defined below), require the approval of the board of directors, unless another manner of approval is provided by the articles of association. See Item 10: Additional Information Interested Parties Transactions. Accordingly, to provide our Chief Executive Officer flexibility in hiring officers (other than directors), Article 50(b) of our Articles of Association authorizes our Chief Executive Officer to appoint our officers and employees (other than directors) and to determine their remuneration as long as the board of directors did not do so, and provides further that the remuneration of the four highest salaried personnel of our company shall be approved by either the board of directors, the Audit Committee or the Compensation Committee.

An extraordinary transaction is defined in the Companies Law as a transaction which is not in the company s ordinary course of business, or is not on market terms, or that may materially affect the company s profitability, assets or liabilities.

An office holder is defined in the Companies Law as a director, general manager, chief business manager, deputy general manager, or any other person assuming the responsibilities of any of the foregoing positions without regard to such person s title, and any other manager directly subordinate to the general manager.

Transfer of Shares

Fully paid ordinary shares are issued in registered form and may be freely transferred pursuant to the Articles of Association, unless such transfer is restricted or prohibited by another instrument.

Acquisition of Shares over Certain Thresholds

The Companies Law provides that an acquisition of shares in our company must be made by means of a tender offer, if, as a result of the acquisition, the purchaser would become a holder of twenty five percent or more of the voting rights in our company. This rule does not apply if there is already another holder of twenty five percent of the voting rights. Similarly, the Companies Law provides that an acquisition of our shares must be made by means of a tender offer, if, as a result of the acquisition, the purchaser would become a holder of forty five percent of the voting rights in t our company, unless there is another person holding at that time more than fifty percent of the voting rights of our company.

Regulations under the Companies Law provide that the Companies Law s tender offer rules do not apply to a company whose shares are publicly traded either outside of Israel or both in and outside of Israel if, pursuant to the applicable foreign securities laws and stock exchange rules, there is a restriction on the acquisition of any level of control of the company or if the acquisition of any level of control of the company requires the purchaser to make a tender offer to the public shareholders.

Repurchase of Shares

The Companies Law, subject to certain limitations, allows companies under certain circumstances to repurchase their own shares. Article 10(b) of our Articles of Association provides that we may at any time, and from time to time, subject to the Companies Law, purchase back or finance the purchase of any shares or other securities issued by us, in such manner and under such terms as our board of directors shall determine, whether from one or more shareholders. Such purchase shall not be deemed a payment of dividends and no shareholder will have the right to require us to purchase his shares or offer to purchase shares from any other shareholders.

Foreign Ownership

Neither our Articles of Association nor Israeli law restrict in any way the ownership of our ordinary shares by nonresidents of Israel, or restrict the voting or other rights of nonresidents of Israel. Notwithstanding, nationals of certain countries that are, or have been, in a state of war with Israel may not be recognized as owners of ordinary shares, without a special government permit.

Mergers

The Companies Law provides for mergers between Israeli companies, if each party to the transaction obtains the appropriate approval of its board of directors and shareholders. A merger is defined in the Companies Law as a transfer of all assets and liabilities (including conditional, future, known and unknown liabilities) of a target company to another company, the consequence of which is the dissolution of the target company in accordance with the provisions of the Companies Law. For purposes of the shareholder vote of each merging entity, unless a court rules otherwise, the merger requires the approval of a majority of the shares of that entity that are not held by the other entity or are not held by any person who holds 25% or more of the shares or the right to appoint 25% or more of the directors of the other entity. Article 69A of our Articles of Association provides that a merger requires the approval of the holders of a majority of the shares voting thereon.

Distribution of Dividends and Liquidation Rights

Our ordinary shares are entitled to the full amount of any cash or share dividend declared, in proportion to the paid up nominal value of their respective holdings. In the event of liquidation, after satisfaction of liabilities to creditors, our assets will be distributed to the holders of our ordinary shares in proportion to the paid up nominal value of their respective holdings. Such rights may be affected by the grant of preferential dividend or distribution rights to the holders of a class of shares with preferential rights that may be authorized in the future by the shareholders.

Generally, pursuant to the Companies Law, the decision to distribute dividends and the amount to be distributed, whether interim or final, is made by the board of directors. Accordingly, under Article 52 of our Articles of Association, our board of directors has the authority to determine the amount and time for payment of interim dividends and final dividends.

Under the Companies Law, dividends may be paid only out of its net profits for the two years preceding the distribution of the dividends, calculated in the manner prescribed in the Companies Law. Pursuant to the Companies Law, in any distribution of dividends, our board of directors is required to determine that there is no reasonable concern that the distribution of dividends will prevent us from meeting our existing and foreseeable obligations as they become due. Our Articles of Association provide that no dividends shall be paid otherwise than out of our profits and that any such dividend shall carry no interest. In addition, upon the recommendation of our board of directors, approved by the shareholders, we may cause dividends to be paid in kind.

Modification of Class Rights

The rights attached to any class of shares (unless otherwise provided by the terms of issue of such class), such as voting, dividends and the like, may be modified by the affirmative vote of a majority of the issued shares of the class at a general meeting of the holders of the shares of such class.

Interested Parties Transactions

The Companies Law requires that certain transactions, actions and arrangements be approved by the Audit Committee as well as by our board of directors. In certain circumstances, in addition to Audit Committee and board of directors approval, approval by our shareholders at a general meeting is also required. Specifically, the approval of our Audit Committee, board of directors and shareholders is required with respect to the following:

- a director's terms of service and employment, including, among other things, grant of exemptions, insurance and indemnification;

extraordinary transactions (as defined above) with (i) controlling shareholders, or (ii) another person or entity in which transaction a controlling shareholder has a personal interest, including a private placement which is an extraordinary transaction; and

the terms of engagement or employment with a controlling shareholder who is also an office holder or an employee of our company.

The approval of our shareholders would be required in addition to the approval of our board of directors, in (i) any transaction in which the majority of our directors have a personal interest, and (ii) private offering which includes one of the following: (a) a private placement of at least 20% of the Company s securities prior to the private offering when the compensation for such placement is not in cash or in securities which are registered for public trade, or when the transaction is not in the ordinary course of business, and that as a result of such private offering the holdings of a shareholder that holds five percent or more of our outstanding share capital shall increase, or that will cause any person to become, as a result of the issuance, a holder of more than five percent of our outstanding share capital; or (b) a private placement of securities that will cause any person to become a controlling shareholder. (clause 270(5))

For the purpose of approvals of interested parties transactions, a controlling shareholder is defined under the Companies Law as: (i) a shareholder having the ability to direct the acts of the company (for this purpose, any person holding one half or more of the voting power of the company or of the right to appoint directors or the Chief Executive Officer is presumed to have control of the company); or (ii) the holder of twenty five percent or more of the voting rights at the general meeting of the company, if there is no other person holding more than fifty percent of such rights (for this purpose, two or more holders having a personal interest in the transaction shall be deemed to be joint holders).

The Companies Law requires a special majority of shareholder votes in approving the transactions with a controlling shareholder referenced in paragraphs (2) and (3) above. The special majority approval must comply with one of the following: (a) it must include at least one-third of all of the votes of the shareholders voting at the meeting who do not have a personal interest in the transaction, or (b) the total number of opposing votes from amongst the shareholders who do not have a personal interest in the transaction does not exceed one percent of all of the voting power of the Company.

The disclosure provisions of the Companies Law require certain disclosure to be made to our company in connection with interested parties transactions, as follows:

an office holder or a controlling shareholder promptly disclose any direct or indirect personal interest (excluding personal interest caused by the holding of company shares) that he may have, and all related information known to him, in connection with any existing or proposed transaction by our company;

in the event of a private placement that will increase the holdings of any shareholder holding more than five percent of our outstanding share capital, or that will cause any person to become, as a result of the issuance, a holder of more than five percent of our outstanding share capital, or that will cause any person to become, as a result of the issuance, a controlling shareholder, such shareholder must promptly disclose to us any personal interest he may have in such private placement; and

any of our shareholders voting on any transaction with a controlling shareholder as set forth above must inform us prior to the voting, or on the proxy card if applicable, of any personal interest he has in the transaction. The vote of a shareholder who does not inform us with respect to any such interest shall not be counted.

In addition, a director who has a personal interest in a transaction, except a transaction with an office holder or in which an office holder has a personal interest but which is not an extraordinary transaction, may not be present or vote at a meeting of the Audit Committee or the board of directors, unless a majority of directors in the Audit Committee or the board of directors, as applicable, have a personal interest in the transaction.

Exemption, Indemnification and Insurance of Directors and Officers

The Companies Law describes the fiduciary duty of an office holder as a duty to act in good faith and for the benefit of the company, including by refraining from actions in which he has a conflict of interest or that compete with the company s business, refraining from exploiting a business opportunity of the company in order to gain a benefit for himself or for another person, and disclosing to the company any information and documents which are relevant to the company and that were obtained by him in his or her capacity as an office holder. The duty of care is defined as an obligation of caution of an office holder that requires the office holder to act at a level of competence at which a reasonable office holder would have acted in the same position and under the same circumstances, including by adopting reasonable means for obtaining information concerning the profitability of the act brought for his approval.

Under the Companies Law, a company may not exempt an office holder from liability with respect to a breach of his fiduciary duty, but may exempt in advance an office holder from his liability to the company, in whole or in part, with respect to a breach of his duty of care.

Pursuant to the Companies Law, a company may indemnify an office holder against a monetary liability imposed on him by a court, including in settlement or arbitration proceedings, and against reasonable legal expenses in a civil proceeding or in a criminal proceeding in which the office holder was found to be innocent or in which he was convicted of an offense which does not require proof of a criminal intent. The indemnification of an office holder must be expressly allowed in the articles of association, under which the company may (i) undertake in advance to indemnify its office holders with respect to categories of events that can be foreseen at the time of giving such undertaking and up to an amount determined by the board of directors to be reasonable under the circumstances, or (ii) provide indemnification retroactively at amounts deemed to be reasonable by the board of directors.

A company may also procure insurance of an office holder s liability in consequence of an act performed in the scope of his office, in the following cases: (a) a breach of the duty of care of such office holder, (b) a breach of the fiduciary duty, only if the office holder acted in good faith and had reasonable grounds to believe that such act would not be detrimental to the company, or (c) a monetary obligation imposed on the office holder for the benefit of another person.

A company may not indemnify an office holder against, nor enter into an insurance contract which would provide coverage for, any monetary liability incurred as a result of any of the following:

- a breach by the office holder of his fiduciary duty unless the office holder acted in good faith and had a reasonable basis to believe that the act would not prejudice the company;

- a breach by the office holder of his duty of care if such breach was done intentionally or recklessly;

- any act or omission done with the intent to derive an illegal personal gain; or

- any fine or penalty levied against the office holder as a result of a criminal offense.

In addition, under the Companies Law, indemnification of, and procurement of insurance coverage for a company s office holders, must be approved by the company s audit committee and board of directors and, in specified circumstances, by the company s shareholders.

73

Our Articles of Association allow us to exempt any office holder to the maximum extent permitted by law, before or after the occurrence giving rise to such exemption. Our Articles of Association also provide that we may indemnify any office holder, to the maximum extent permitted by law, against any liabilities he or she may incur in such capacity, limited with respect (i) to the categories of events that can be foreseen in advance by our board of directors when authorizing such undertaking and (ii) to the amount of such indemnification as determined retroactively by our board of directors to be reasonable in the particular circumstances. Similarly, we may also agree to indemnify an office holder for past occurrences, whether or not we are obligated under any agreement to provide such indemnification. We have obtained directors and officers liability insurance covering our officers and directors and those of our subsidiaries for certain claims. In addition, as of August 30, 2005, we have provided our directors and officers with letters providing them with indemnification to the fullest extent permitted under Israeli law.

Our Articles of Association also allow us to procure insurance covering any past or present officer holder against any liability which he or she may incur in such capacity, to the maximum extent permitted by law. Such insurance may also cover the Company for indemnifying such office holder.

C. Material Contracts

While we have numerous contracts with customers and distributors we do not deem any such individual contract to be material.

D. Exchange Controls

The Israeli Currency Control Law, 5738-1978 provides that transactions in foreign currencies, and transactions with foreign residents, require a permit. Since 1998, when a new general permit was issued under the law, there have been no Israeli currency control restrictions on payments of dividends or other distributions with respect to our ordinary shares or the proceeds from the sale of the shares, except for the obligation of Israeli residents to file reports with the Bank of Israel regarding certain transactions.

E. Taxation

The following is a discussion of Israeli and United States tax consequences material to our shareholders. To the extent that the discussion is based on new tax legislation which has not been subject to judicial or administrative interpretation, the views expressed in the discussion might not be accepted by the tax authorities in question. The discussion is not intended, and should not be construed, as legal or professional tax advice and does not exhaust all possible tax considerations.

ISRAELI TAXATION

The following is a summary of certain Israeli income tax and capital gains tax consequences for nonresidents and residents of Israel holding our ordinary shares. The summary is based on provisions of the Israeli Income Tax Ordinance (new version) and additional and complementary tax regulations promulgated thereunder, and on administrative and judicial interpretations, all as currently in effect, and all of which are subject to change (possibly with retroactive effect) and to differing interpretations. There might be changes in the tax rates and in the circumstances in which they apply, and other modifications which might change the tax consequences to you. The summary is intended for general purposes only, and is not exhaustive of all possible tax considerations. The discussion is not intended and should not be construed as legal or professional tax advice and is not exhaustive of all possible tax considerations. This summary does not discuss all aspects of Israeli income and capital gain taxation that may be applicable to investors in light of their particular circumstances or to investors who are subject to special status or treatment under Israeli tax law.

FOR THE FOREGOING AND OTHER REASONS, YOU ARE URGED TO CONSULT YOUR OWN TAX ADVISOR REGARDING THE TAX CONSEQUENCES OF YOUR HOLDINGS. WE ARE NOT MAKING ANY REPRESENTATIONS REGARDING THE PARTICULAR TAX CONSEQUENCES AS TO ANY HOLDER, NOR ARE WE OR OUR ADVISORS RENDERING ANY FORM OF LEGAL OPINION OR PROFESSIONAL TAX ADVICE AS TO SUCH TAX CONSEQUENCES.

Generally, Israeli companies are subject to Corporate Tax on their taxable income. On July 25, 2005, the Knesset, Israel s Parliament, approved the Law of the Amendment of the Income Tax Ordinance (Amendment No. 147), 2005, effective commencing January 1, 2006, which prescribes, among others, a gradual decrease in the corporate tax rate in Israel to the following tax rates: in 2005 34%, in 2006 31%, in 2007 29%, in 2008 27%, in 2009 26% and in 2010 and thereafter 25%. However, the effective tax rate payable by a company which derives income from an approved enterprise (as further discussed below) may be considerably less.

Following an additional amendment to the Tax Ordinance, which came into effect on January 1, 2009, an Israeli corporation may elect a 5% rate of corporate tax (instead of 25%) for income from dividend distributions received from a foreign subsidiary which is used in Israel in 2009, or within one year after actual receipt of the dividend, whichever is later. The 5% tax rate is subject to various conditions, which include conditions with regard to the identity of the corporation that distributes the dividends, the source of the dividend, the nature of the use of the dividend income, and the period during which the dividend income will be used in Israel.

Tax Consequences to Nonresidents of Israel

Nonresidents of Israel are subject to income tax on income accrued or derived from sources in Israel. These sources of income include passive income such as dividends, royalties and interest, as well as non-passive income from services rendered in Israel. We are required to withhold income tax on such payments to non-residents. Israel presently has no estate or gift tax.

Capital Gains

Israeli law generally imposes a capital gains tax on capital gains derived from the sale of securities and other Israeli capital assets, including shares in Israeli resident companies, unless a specific exemption is available or unless a treaty between Israel and the country of the non-resident provides otherwise. The capital gain or loss amount is equal to the consideration received by the holder for the shares less the holder s tax basis in the shares. Gains from sales of our ordinary shares will be tax exempt for nonresidents of Israel if the shares are quoted on the NASDAQ Global Market or listed for trading on a stock exchange so long as the gains are not derived through a permanent establishment that the non-resident maintains in Israel.

For residents of the United States holding less than 10% of our shares at any time in the twelve months before the sale, under the treaty between Israel and the U.S., capital gains from the sale of capital assets are generally exempt from Israeli capital gains tax with respect to the exceptions stated in the treaty.

Dividends

Nonresidents of Israel are subject to income tax on income accrued or derived from sources in Israel. These sources of income may include dividends on our ordinary shares. As of January 1, 2006, income tax on distributions of dividends other than bonus shares (stock dividends) is at the rate of 20% for dividends paid to an individual or a foreign corporation who is not a substantial shareholder, 25% for dividends paid to a substantial shareholder, and 15% for dividends generated by an approved enterprise, a different rate is provided in a treaty between Israel and shareholder s country of residence.

Under the U.S.-Israel tax treaty, the maximum tax on dividends paid to a holder of ordinary shares who is a U.S. resident will be 25%. However, the maximum tax rate on dividends not generated by an approved enterprise paid to a US corporation holding at least 10% of our voting power is 12.5%. For residents of other countries, unless a different rate is provided in a treaty between Israel and the shareholder s country of residence, the maximum tax on dividends paid that we are required to withhold is 20%. As long as our shares are listed on a stock exchange, the maximum withholding tax rate will be 20%.

Interest

Nonresidents of Israel are subject to income tax on income accrued or derived from sources in Israel. These sources of income may include passive income, such as interest paid on our convertible notes. For residents of the United States, under the treaty between Israel and the U.S., the maximum tax on interest paid to a U.S. resident (as defined in the treaty) holding our convertible notes that we are required to withhold is 17.5%. For residents of other countries who are not substantial shareholders, unless a different rate is provided in a treaty between Israel and the country of residence of such holder of our convertible notes, the maximum tax that we are required to withhold is 25% on all distributions of interest. Substantial shareholders may be subject to an increased withholding tax rate, up to the marginal tax rate.

Filing of Tax Returns in Israel

A nonresident of Israel who receives interest, dividend or royalty income derived from or accrued in Israel, from which tax was withheld at the source, is generally exempt from the duty to file tax returns in Israel with respect to such income, provided such income was not derived from a business conducted in Israel by the taxpayer.

Tax Consequences to Residents of Israel

Capital Gains

Israeli law imposes a capital gains tax on capital gains derived from the sale of securities and other Israeli capital assets, including shares by Israeli residents. The capital gain or loss amount is equal to the consideration received by the holder for the shares less the holder s tax basis in the shares. Under current law, following Amendment No. 147, gains from sales of ordinary shares incurred after December 31, 2002, are subject to 20% capital gains tax (25% for substantial shareholder) for individuals, Israeli companies that were subject to the Income Tax Law (Inflation Adjustments) 1985 (the Adjustment Law) prior to the publication of Amendment No. 147 are subject to corporate tax rate on capital gain driven from the sale of our ordinary shares, Israeli companies that were not subject to the Adjustment law prior to the publication of Amendment No. 147 are subject to capital gain tax at a rate of 25% in connection with the sale of our ordinary shares. If our ordinary shares were purchased prior to January 1, 2003, different taxation will apply. Certain withholding obligations may apply on the sale of our shares.

Dividends

Dividend income generated by an Approved Enterprise is subject to income tax at a rate of 15%. Starting January 1, 2006, the distribution of dividend income generated by other sources, other than bonus shares (stock dividends), to Israeli residents who purchased our Shares will generally be subject to income tax at a rate of 20% for individuals (25% for substantial shareholder) and will be exempt from income tax for corporations provided the dividend was paid out of income generated in Israel. We may be required to withhold income tax at the maximum rate of up to 25% (0% for Israeli corporations provided the dividend was paid out of income generated in Israel.) on all such distributions (15% for dividends generated by an Approved Enterprise).

Interest

Interest accrued and paid after January 1, 2006, is generally subject to 20% tax for individuals (the marginal tax rate for substantial shareholder) and the applicable corporate tax rate for companies. On all distributions of interest, we may be required to withhold income tax at a rate of up to the applicable corporate tax rate for companies, and up to the marginal tax rate for individuals.

Tax Benefits under the Law for the Encouragement of Capital Investments, 1959

Tax benefits prior to the amendment of 2005

The Law for the Encouragement of Capital Investments, 1959, as in effect prior to April 1, 2005 (the Investments Law), provides that a capital investment in eligible facilities may, upon application to the Investment Center of the Ministry of Industry, Trade and Labor of the State of Israel, be designated as an approved enterprise. The Investment Center bases its decision as to whether or not to approve an application, among other things, on the criteria set forth in the Investments Law and regulations, the then prevailing policy of the Investment Center, and the specific objectives and financial criteria of the applicant. Each certificate of approval for an approved enterprise relates to a specific investment program delineated both by its financial scope, including its capital sources, and by its physical characteristics, e.g., the equipment to be purchased and utilized pursuant to the program.

The Investments Law provides that an approved enterprise is eligible for tax benefits on taxable income derived from its approved enterprise programs. The tax benefits under the Investments Law also apply to income generated by a company from the grant of a usage right with respect to know-how developed by the approved enterprise, income generated from royalties, and income derived from a service which is related to such usage right or royalties, provided that such income is generated within the approved enterprise s ordinary course of business. If a company has more than one approval or only a portion of its capital investments are approved, its effective tax rate is in general the result of a weighted average of the applicable rates. The tax benefits under the Investments Law might be restricted with respect to income derived from products manufactured outside of Israel. In addition, the tax benefits available to an approved enterprise are contingent upon the fulfillment of conditions stipulated in the Investments Law and regulations and the criteria set forth in the specific certificate of approval, as described above. In the event that a company does not meet these conditions, it would be required to refund the amount of tax benefits, plus a consumer price index linkage adjustment and interest.

The Investments Law also provides that an approved enterprise is entitled to accelerated depreciation on its property and equipment that are included in an approved enterprise program in the first five years of using the equipment.

Taxable income of a company derived from an approved enterprise is subject to corporate tax at the maximum rate of 25%, rather than the regular corporate tax rate, for the benefit period. This period is ordinarily seven years commencing with the year in which the approved enterprise first generates taxable income after the commencement of production, and is limited to 12 years from commencement of production or 14 years from the date of approval, whichever is earlier (the year s limitation).

Should we derive income from sources other than the approved enterprise during the relevant period of benefits, such income will be taxable at the regular corporate tax rates.

Under certain circumstances (as further detailed below), the benefit period may extend to a maximum of ten years from the commencement of the benefit period.

A company may elect to receive an alternative package of benefits. Under the alternative package of benefits, a company s undistributed income derived from the approved enterprise will be exempt from corporate tax for a period of between 2 and 10 years from the first year the company derives taxable income under the program, after the commencement of production, depending on the geographic location of the approved enterprise within Israel, and such company will be eligible for a reduced tax rate for the remainder of the benefits period (but not more than a maximum of 7 to 10 years in total). The limitation of years, as mentioned above, does not apply to the exemption period.

A company that has elected the alternative package of benefits, such as us, that subsequently pays a dividend out of income derived from the approved enterprise(s) during the tax exemption period will be subject to corporate tax in the year the dividend is distributed in respect of the gross amount distributed, at the rate which would have been applicable had the company not elected the alternative package of benefits, (generally 10%-25%, depending on the percentage of the company s ordinary shares held by foreign shareholders). The dividend recipient is subject to withholding tax at the reduced rate of 15% applicable to dividends from approved enterprises, if the dividend is distributed during the tax exemption period or within 12 years thereafter. In the event, however, that the company is qualifies as a Foreign Investors Company, there is no such time limitation.

A company that has an approved enterprise program is eligible for further tax benefits if it qualifies as a foreign investors company. A foreign investors company is a company which, among others, more than 25% of its share capital, including shareholders loans, is owned by non-Israeli residents. A company that qualifies as a foreign investors company and has an approved enterprise program is eligible for tax benefits for a 10 year benefit period.

Tax benefits under the 2005 Amendment

On April 1, 2005, a comprehensive amendment to the investment law came into effect, (the Amendment). The Amendment includes revisions to the criteria for investments qualified to receive tax benefits as an Approved Enterprise. The Amendment applies to new investment programs and investment programs commencing after 2004, and does not apply to investment programs approved prior to December 31, 2004.

However, a company that was granted benefits according to section 51 of the Investment Law (prior the Amendment) would not be allowed to choose a new tax year as a Year of Election (as described below) under the Amendment, for a period of two years from the company s previous Year of Commencement under the old investment law.

As a result of the Amendment, it is no longer necessary for a company to acquire approved enterprise status in order to receive the tax benefits previously available under the alternative route, and therefore such companies do not need to apply to the Investment Center for this purpose. Rather, a company wishing to receive the tax benefits afforded to a Benefited Enterprise is required to select the tax year from which the period of benefits under the Investment Law are to commence by notifying the Israeli Tax Authority within 12 months of the end of that year, provided that its facilities meet the criteria for tax benefits set out by the Amendment, or a Benefited Enterprise. Companies are also granted a right to approach the Israeli Tax Authority for a pre-ruling regarding their eligibility for benefits under the Amendment. The Amendment includes provisions attempting to ensure that a company will not enjoy both Government grants and tax benefits for the same investment program

Our company is entitled to enjoy the tax benefits in accordance with the provisions of the Investment Law prior to its revision, but if our company is granted any new benefits in the future they will be subject to the provisions of the Amendment. The following discussion is a summary of the Investment Law prior to its Amendment as well as the relevant changes contained in the Amendment.

The Amendment simplifies the approval process: according the Amendment, only Approved Enterprises receiving cash grants require the approval of the Investment Center. The Investment Center will be entitled, to approve such programs only until December 31, 2007.

The Amendment does not apply to benefits included in any certificate of approval that was granted before the Amendment came into effect, which will remain subject to the provisions of the Investment Law as they were on the date of such approval.

Tax benefits are available under the Amendment to production facilities (or other eligible facilities), which are generally required to derive more than 25% of their business income from export (referred to as a Benefited Enterprise). In order to receive the tax benefits, the Amendment states that the company must make an investment in the Benefited Enterprise exceeding a certain percentage or a minimum amount specified in the Law. Such investment may be made over a period of no more than three years ending at the end of the year in which the company requested to have the tax benefits apply to the Benefited Enterprise, or the Year of Election. If the company requests to have the tax benefits apply to an expansion of existing facilities, then only the expansion will be considered a Benefited Enterprise and in general the company s effective tax rate will be the result of a weighted combination of the applicable tax rates. In this case, the minimum investment required in order to qualify as a Benefited Enterprise is required to exceed a minimum amount or a certain percentage of the company s production assets at the end of the year before the expansion.

The duration of tax benefits is subject to a limitation of the earlier of 7 to 10 years from the Commencement Year, or 12 years from the first day of the Year of Election. The tax benefits granted to a Benefited Enterprise are determined, as applicable to its geographic location within Israel, according to one of the following new tax routes, which may be applicable to us:

Similar to the alternative route, exemption from corporate tax on undistributed income for a period of two to ten years, depending on the geographic location of the Benefited Enterprise within Israel, and a reduced corporate tax rate of 10% to 25% for the remainder of the benefits period, depending on the level of foreign investment in each year. Benefits may be granted for a term of seven or ten years, depending on the level of foreign investment in the company. If the company pays a dividend out of income derived from the Benefited Enterprise during the tax exemption period, such income will be subject to corporate tax at the applicable rate (10%-25%) in respect of the grossed up amount of the dividend that we may distribute. The company is required to withhold tax at a rate of 15% from any dividends distributed from income derived from the Benefited Enterprise; and

A special tax route, which enables companies owning facilities in certain geographical locations in Israel to pay corporate tax at the rate of 11.5% on income of the Benefited Enterprise. The benefits period is ten years. Upon payment of dividends, the company is required to withhold tax at a rate of 15% for Israeli residents and at a rate of 4% for foreign residents.

If we are granted new benefits in the future, we will be subject to the first route.

Generally, a company that is Abundant in Foreign Investment (as defined in the Investments Law) is entitled to an extension of the benefits period by an additional five years, depending on the rate of its income that is derived in foreign currency.

The Amendment changes the definition of foreign investment in the Investments Law so that the definition now requires a minimal investment of NIS 5 million by foreign investors. Furthermore, such definition now also includes the purchase of shares of a company from another shareholder, provided that the company s outstanding and paid-up share capital exceeds NIS 5 million. Such changes to the aforementioned definition will take effect retroactively from 2003.

The Amendment will apply to approved enterprise programs in which the year of election under the Investments Law is 2004 or later, unless such programs received approval from the Investment Center on or prior to December 31, 2004, in which case the Amendment provides that the terms and benefits included in any certificate of approval already granted will remain subject to the provisions of the law as they were on the date of such approval.

As a result of the Amendment, tax-exempt income generated under the provisions of the Amendment will be subject to taxes upon distribution or liquidation and we may be required in the future to record deferred tax liability with respect to such tax-exempt income.

Israeli Transfer Pricing Regulations

On November 29, 2006, Income Tax Regulations (Determination of Market Terms), 2006, promulgated under Section 85A of the Tax Ordinance, came into effect (the TP Regs). Section 85A of the Tax Ordinance and the TP Regs generally requires that all cross-border transactions carried out between related parties be conducted on an arm s length principle basis and will be taxed accordingly. The TP Regs are not expected to have a material effect on our company.

U.S. TAXATION

The following discussion is a general summary of certain U.S. federal income tax considerations applicable to U.S. Holders (as defined below) of ordinary shares, who hold such ordinary shares as capital assets (generally, property held for investment). This summary is based on provisions of the U.S. Internal Revenue Code, or the Code, existing and proposed U.S. Treasury regulations and administrative and judicial interpretations in effect as of the date of this annual report and the U.S. Israel Tax Treaty. All of these authorities are subject to change (possibly with retroactive effect) and to differing interpretations. In addition, this summary does not discuss non-U.S. tax implications or U.S. state tax implications, no does it discuss all aspects of U.S. federal income taxation that may be applicable to investors in light of their particular circumstances or to investors who are subject to special treatment under U.S. federal income tax law, including:

- insurance companies;
- dealers in stocks or securities;
- financial institutions;
- tax-exempt organizations;
- regulated investment companies or real estate investment trusts;
- persons subject to the alternative minimum tax;
- persons who hold ordinary shares through partnerships or other pass-through entities;
- persons holding their shares as part of a straddle or appreciated financial position or as part of a hedging or conversion transaction;
- persons who acquired their ordinary shares through the exercise or cancellation of employee stock options or otherwise as compensation for services;
- non-residents aliens of the U.S. or persons having a functional currency other than the U.S. dollar; or
- direct, indirect or constructive owners of 10% or more of the outstanding voting shares of our company.

If a partnership or an entity treated as a partnership for U.S. federal income tax purposes owns ordinary shares, the U.S. federal income tax treatment of a partner in such a partnership will generally depend upon the status of the partner and the activities of the partnership. A partnership that owns ordinary shares and the partners in such partnership should consult their tax advisors about the U.S. federal income tax consequences of holding and disposing of ordinary shares.

THE FOLLOWING SUMMARY DOES NOT ADDRESS THE IMPACT OF A U.S. HOLDER S INDIVIDUAL TAX CIRCUMSTANCES. ACCORDINGLY, EACH U.S. HOLDER IS URGED TO CONSULT HIS OR HER TAX ADVISOR AS TO THE PARTICULAR TAX CONSEQUENCES TO HIM OR HER OF AN INVESTMENT IN THE ORDINARY SHARES, INCLUDING THE EFFECTS OF APPLICABLE STATE, LOCAL OR NON-U.S. TAX LAWS AND POSSIBLE CHANGES IN THE TAX LAWS.

As used herein, the term U.S. Holder means a beneficial owner of an ordinary share who is, for U.S. federal income tax purposes:

- a citizen or, for U.S. federal income tax purposes, a resident of the United States;

a corporation created or organized in or under the laws of the United States or any political subdivision thereof;

an estate, the income of which is subject to U.S. federal income taxation regardless of its source; or

a trust if (i) (A) a U.S. court is able to exercise primary supervision over the trust's administration and (B) one or more U.S. persons have the authority to control all of the trust's substantial decisions, or (ii) it has a valid election in effect under applicable U.S. Treasury regulations to be treated as a U.S. person.

Dividends Paid on Ordinary Shares

Subject to the discussion of the passive foreign investment company or PFIC rules below, a U.S. Holder generally will be required to include in gross income as ordinary dividend income the amount of any distributions paid on the ordinary shares (including the amount of any Israeli taxes withheld) to the extent that such distributions are paid out of our current or accumulated earnings and profits as determined for U.S. federal income tax purposes. Distributions in excess of our earnings and profits will be applied against and will reduce the U.S. Holder s tax basis in its ordinary shares and, to the extent they are in excess of such tax basis, will be treated as gain from a sale or exchange of such ordinary shares. Our dividends will not qualify for the dividends-received deduction otherwise available to U.S. corporations. In the event that we pay cash dividends, such dividends will be paid in Israeli currency. Dividends paid in NIS (including the amount of any Israeli taxes withheld therefrom) will be includible in the gross income of a U.S. Holder in a U.S. dollar amount calculated by reference to the exchange rate in effect on the day they are received by the U.S. Holder. Any gain or loss resulting from currency exchange fluctuations during the period from the date the dividend is includible in the income of the U.S. Holder to the date such payment is converted into U.S. dollars generally will be treated as U.S. source ordinary income or loss.

Subject to certain limitations, qualified dividend income received by a non-corporate taxpayer generally is subject to U.S. federal income tax at a reduced maximum tax rate of 15 percent through December 31, 2010. Dividends received with respect to ordinary shares should qualify for the 15 percent rate provided that either: (i) we are entitled to benefits under the income tax treaty between the United States and Israel (the Treaty); or (ii) the ordinary shares currently are readily tradable on an established securities market in the U.S.. We believe that we are entitled to benefits under the Treaty and that the ordinary shares currently are readily tradable on an established securities market in the U.S. No assurance can be given that the ordinary shares will remain readily tradable. The rate reduction does not apply to dividends received from PFICs, see discussion below, or in respect of certain short-term or hedged positions in common stock or in certain other situations. The legislation enacting the reduced tax rate contains special rules for computing the foreign tax credit limitation of a taxpayer who receives dividends subject to the reduced tax rate, see discussion below. U.S. Holders of ordinary shares should consult their own tax advisors regarding the effect of these rules in their particular circumstances.

Subject to complex limitations, any Israeli withholding tax imposed on dividends paid by us will be a foreign income tax eligible for credit against a U.S. Holder s U.S. federal income tax liability (or, alternatively, for deduction against income in determining such tax liability). The limitations set out in the Code include computational rules under which foreign tax credits allowable with respect to specific classes of income cannot exceed the U.S. federal income taxes otherwise payable with respect to each such class of income. Dividends generally will be treated as foreign-source passive category income or, in the case of certain U.S. Holders, general category income for United States foreign tax credit purposes. Further, there are special rules for computing the foreign tax credit limitation of a taxpayer who receives dividends subject to a reduced tax, see discussion above. A U.S. Holder will be denied a foreign tax credit with respect to Israeli income tax withheld from dividends received on the ordinary shares to the extent such U.S. Holder has not held the ordinary shares for at least 16 days of the 31-day period beginning on the date which is 15 days before the ex-dividend date or to the extent such U.S. Holder is under an obligation to make related payments with respect to substantially similar or related property. Any days during which a U.S. Holder has substantially diminished its risk of loss on the ordinary shares are not counted toward meeting the 16-day holding period required by the statute. The rules relating to the determination of the foreign tax credit are complex, and you should consult with your personal tax advisors to determine whether and to what extent you would be entitled to this credit.

Sale or Disposition of Ordinary Shares

Subject to the discussion of PFIC rules below, upon the sale or other disposition of ordinary shares, a U.S. Holder generally will recognize capital gain or loss equal to the difference between the amount realized on the disposition and such holder s adjusted tax basis in the ordinary shares disposed of. Gain or loss upon the disposition of ordinary shares will be long-term capital gain or loss if, at the time of the disposition, the U.S. Holder s holding period for the ordinary shares disposed of exceeds one year. In general, any gain that you recognize on the sale or other disposition of ordinary shares will be U.S.-source for purposes of the foreign tax credit limitation; losses will generally be allocated against U.S. source income. Deduction of capital losses is subject to certain limitations under the Code.

In the case of a cash basis U.S. Holder who receives NIS in connection with the sale or disposition of ordinary shares, the amount realized will be based on the U.S. dollar value of the NIS received with respect to the ordinary shares as determined on the settlement date of such exchange. A U.S. Holder who receives payment in NIS and converts NIS into United States dollars at a conversion rate other than the rate in effect on the settlement date may have a foreign currency exchange gain or loss that would be treated as ordinary income or loss.

An accrual basis U.S. Holder may elect the same treatment required of cash basis taxpayers with respect to a sale or disposition of ordinary shares, provided that the election is applied consistently from year to year. Such election may not be changed without the consent of the Internal Revenue Service, or the IRS. In the event that an accrual basis U.S. Holder does not elect to be treated as a cash basis taxpayer (pursuant to the Treasury regulations applicable to foreign currency transactions), such U.S. Holder may have a foreign currency gain or loss for U.S. federal income tax purposes because of differences between the U.S. dollar value of the currency received prevailing on the trade date and the settlement date. Any such currency gain or loss would be treated as ordinary income or loss and would be in addition to gain or loss, if any, recognized by such U.S. Holder on the sale or disposition of such ordinary shares.

Passive Foreign Investment Company

For U.S. federal income tax purposes, we will be considered a PFIC for any taxable year in which either (i) 75% or more of our gross income is passive income, or (ii) at least 50% of the average value of all of our assets for the taxable year produce or are held for the production of passive income. For this purpose, passive income includes dividends, interest, royalties, rents, annuities and the excess of gains over losses from the disposition of assets which produce passive income. If we were determined to be a PFIC for U.S. federal income tax purposes, highly complex rules would apply to U.S. Holders owning ordinary shares. Accordingly, you are urged to consult your tax advisors regarding the application of such rules.

Based on our current and projected income, assets and activities, we believe that we were not a PFIC in the year 2008. However, because the determination of whether we are a PFIC is based upon the composition of our income and assets from time to time, there can be no assurances that we will not become a PFIC for any future taxable year.

If we were treated as a PFIC for any taxable year, dividends would not qualify for the reduced maximum tax rate, discussed above, and, unless you elect either to treat your investment in ordinary shares as an investment in a qualified electing fund , or a QEF election, or to mark-to-market your ordinary shares, as described below:

you would be required to allocate income recognized upon receiving certain dividends or gain recognized upon the disposition of ordinary shares ratably over the holding period for such ordinary shares,

the amount allocated to each year during which we are considered a PFIC and subsequent years, other than the year of the dividend payment or disposition, would be subject to tax at the highest individual or corporate tax rate, as the case may be, in effect for that year and an interest charge would be imposed with respect to the resulting tax liability allocated to each such year,

the amount allocated to the current taxable year and any taxable year before we became a PFIC would be taxable as ordinary income in the current year, and

you would be required to make an annual return on IRS Form 8621 regarding distributions received with respect to ordinary shares and any gain realized on your ordinary shares.

If you make either a timely QEF election or a timely mark-to-market election in respect of your ordinary shares, you would not be subject to the rules described above. If you make a timely QEF election, you would be required to include in your income for each taxable year your pro rata share of our ordinary earnings as ordinary income and your pro rata share of our net capital gain as long-term capital gain, whether or not such amounts are actually distributed to you. You would not be eligible to make a QEF election unless we comply with certain applicable information reporting requirements.

Alternatively, if the ordinary shares are considered marketable stock and if you elect to mark-to-market your ordinary shares, you will generally include in income any excess of the fair market value of the ordinary shares at the close of each tax year over your adjusted basis in the ordinary shares. If the fair market value of the ordinary shares had depreciated below your adjusted basis at the close of the tax year, you may generally deduct the excess of the adjusted basis of the ordinary shares over its fair market value at that time. However, such deductions generally would be limited to the net mark-to-market gains, if any, that you included in income with respect to such ordinary shares in prior years. Income recognized and deductions allowed under the mark-to-market provisions, as well as any gain or loss on the disposition of ordinary shares with respect to which the mark-to-market election is made, is generally treated as ordinary income or loss.

Backup Withholding and Information Reporting

Payments in respect of ordinary shares may be subject to information reporting to the U.S. Internal Revenue Service and to U.S. backup withholding tax at a rate equal to the fourth lowest income tax rate applicable to individuals (which, under current law, is 28%). Backup withholding will not apply, however, if you (i) are a corporation or come within certain exempt categories, and demonstrate the fact when so required, or (ii) furnish a correct taxpayer identification number and make any other required certification.

Backup withholding is not an additional tax. Amounts withheld under the backup withholding rules may be credited against a U.S. Holder s U.S. tax liability, and a U.S. Holder may obtain a refund of any excess amounts withheld under the backup withholding rules by filing the appropriate claim for refund with the IRS.

Any U.S. holder who holds 10% or more in vote or value of our ordinary shares will be subject to certain additional United States information reporting requirements.

F. Dividend and Paying Agents

Not applicable.

G. Statement by Experts

Not applicable.

H. DOCUMENTS ON DISPLAY

We are subject to certain of the reporting requirements of the Securities and Exchange Act of 1934, as amended, or the Exchange Act, as applicable to foreign private issuers as defined in Rule 3b-4 under the Exchange Act. As a foreign private issuer, we are exempt from certain provisions of the Exchange Act. Accordingly, our proxy solicitations are not subject to the disclosure and procedural requirements of Regulation 14A under the Exchange Act, and transactions in our equity securities by our officers and directors are exempt from reporting and the short-swing profit recovery provisions contained in Section 16 of the Exchange Act. In addition, we are not required under the Exchange Act to file periodic reports and financial statements as frequently or as promptly as U.S. companies whose securities are registered under the Exchange Act. However, we file with the Securities and Exchange Commission an annual report on Form 20-F containing financial statements audited by an independent accounting firm. We also submit to the Securities and Exchange Commission reports on Form 6-K containing (among other things) press release and unaudited financial information. We post our annual report on Form 20-F on our website (http://www.gilat.com) promptly following the filing of our annual report with the Securities and Exchange Commission. The information on our website is not incorporated by reference into this annual report.

This annual report and the exhibits thereto and any other document we file pursuant to the Exchange Act may be inspected without charge and copied at prescribed rates at the Securities and Exchange Commission public reference room at 100 F Street, N.E., Room 1580, Washington, D.C. 20549. You may obtain information on the operation of the Securities and Exchange Commission s public reference room in Washington, D.C. by calling the Securities and Exchange Commission at 1-800-SEC-0330. The Exchange Act file number for our Securities and Exchange Commission filings is 000-21218.

The Securities and Exchange Commission maintains a website at www.sec.gov that contains reports, proxy and information statements, and other information regarding registrants that make electronic filings with the Securities and Exchange Commission using its EDGAR (Electronic Data Gathering, Analysis, and Retrieval) system.

The documents concerning our company that are referred to in this annual report may also be inspected at our offices located at Gilat House, 21 Yegia Kapayim Street, Kiryat Arye, Petah Tikva, 49130 Israel.

I. Subsidiary Information

Not applicable

ITEM 11: QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

The table below details our balance sheet exposure by currency and interest rates:

	Expected Maturity Dates				
	2009	2010	2011	2012	2013 and thereafter
	(In thousands)				
Assets:					
Restricted cash - in U.S. dollars	8,548	750	500	500	3,901
Weighted interest rate	3.01%	0.52%	0.65%	0.65%	0.67%
In other currency	33	41			
Weighted interest rate	2.5%	0%			
Restricted cash held by Trustees					
In U.S. dollars	19,434				
Weighted interest rate	2%				
In other currency	4,735				
Weighted interest rate	10.03%				
Liabilities:					
Long-term loans (including current maturities)					
In U.S. dollars:	4,000	4,000	4,000		
Weighted interest rate	4.65%	4.65%	4.65%		
In other currency:	346	368	5,635		
Weighted interest rate	6.3%	6.3%	6.3%		
Converted subordinated notes - in U.S. dollars:		853	853	14,609	
Weighted interest rate		4.00%	4.00%	4.00%	

ITEM 12: DESCRIPTION OF SECURITIES OTHER THAN EQUITY SECURITIES

Not applicable.

PART II

ITEM 13: DEFAULTS, DIVIDEND ARREARAGES AND DELINQUENCIES

None

ITEM 14: MATERIAL MODIFICATIONS TO THE RIGHTS OF SECURITY HOLDERS AND USE OF PROCEEDS

Not applicable.

ITEM 15: CONTROLS AND PROCEDURES

Disclosure Controls and Procedures

Our principal executive officer and chief financial officer, after evaluating the effectiveness of our disclosure controls and procedures (as defined in Rule 13a-15(e) of the Securities Exchange Act of 1934, as amended) as of December 31, 2008, have concluded that, as of such date, our disclosure controls and procedures were effective and ensured that information required to be disclosed by us in reports that we file or submit under the Securities Exchange Act is accumulated and communicated to our management, including our principal executive officer and chief financial officer, to allow timely decisions regarding required disclosure and is recorded, processed, summarized and reported within the time periods specified by the rules of the Securities and Exchange Commission.

Management s Annual Report on Internal Control over Financial Reporting

Our management is responsible for establishing and maintaining adequate internal control over our financial reporting. Internal control over financial reporting is defined in Rule 13a-15(f) or 15d-15(f) promulgated under the Securities Exchange Act of 1934 as a process designed by, or under the supervision of, the company s principal executive and principal financial officers and effected by the company s board of directors, management and other personnel, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles and includes those policies and procedures that:

Pertain to the maintenance of records that in reasonable detail accurately and fairly reflect the transaction and dispositions of the assets of the company;

Provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and

Provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use of disposition of the company s assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

Our management assessed the effectiveness of our internal control over financial reporting, as of December 31, 2008. In making this assessment, our management used the criteria set forth by the Committee of Sponsoring Organizations of the Treadway Commission (COSO) in Internal Control-Integrated Framework.

Based on that assessment, our management concluded that as of December 31, 2008, our internal control over financial reporting is effective.

Our independent auditors, Kost Forer Gabbay & Kasierer, a member of Ernst & Young Global, have issued an audit report on the effectiveness of our internal control over financial reporting. The report is included in page F-3 of this Annual Report on Form 20-F.

Changes in Internal Control over Financial Reporting

During the period covered by this Annual Report on Form 20-F, no changes in our internal control over financial reporting have occurred that materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

ITEM 16: RESERVED

ITEM 16A: AUDIT COMMITTEE FINANCIAL EXPERT

Our board of directors has determined that Dr. Meridor and Dr. Sarid meet the definition of an audit committee financial expert, as defined in Item 401 of Regulation S-K.

ITEM 16B: CODE OF ETHICS

We have adopted a Code of Ethics for executive and financial officers, that also applies to all of our employees. The Code of Ethics is publicly available on our website at www.gilat.com. Written copies are available upon request. If we make any substantive amendments to the Code of Ethics or grant any waivers, including any implicit waiver, from a provision of this code to our chief executive officer, principal financial officer or corporate controller, we will disclose the nature of such amendment or waiver on our website.

ITEM 16C: PRINCIPAL ACCOUNTANT FEES AND SERVICES

Fees Billed by Independent Auditors

The following table sets forth, for each of the years indicated, the fees billed to us by our independent auditors and the percentage of each of the fees out of the total amount paid to the auditors.

	Year Ended December 31,			
	2008		2007	
Services Rendered	Fees	Percentages	Fees	Percentages
Audit fees (1)	$ 872,643	98.2%	$ 788,211	97.6%
Tax fees (2)	15,520	1.8%	19,500	2.4%
Total	$ 888,163	100.0%	$ 807,711	100.0%

(1) Audit fees are fees for audit services for each of the years shown in this table, including fees associated with the annual audit, services provided in connection with audit of our internal control over financial reporting and audit services provided in connection with other statutory or regulatory filings.

(2) Tax fees are fees for professional services rendered by our auditors for tax compliance, tax planning and tax advice on actual or contemplated transactions.

87

Policies and Procedures

Our Audit Committee has adopted a policy and procedures for the approval of audit and non-audit services rendered by our independent auditors, Kost Forer Gabbay & Kasierer, a Member of Ernst & Young Global. The policy generally requires the Audit Committee s approval of the scope of the engagement of our independent auditor or on an individual engagement basis. The policy prohibits retention of the independent auditors to perform the prohibited non-audit functions defined in Section 201 of the Sarbanes-Oxley Act of 2002 or the rules of the SEC, and also considers whether proposed services are compatible with the independence of the public auditors.

ITEM 16D. EXEMPTIONS FROM THE LISTING STANDARDS FOR AUDIT COMMITTEES

Not applicable.

ITEM 16E: PURCHASE OF EQUITY SECURITIES BY THE ISSUER AND AFFILIATED PURCHASERS

Issuer Purchase of Equity Securities

In the year ended December 31, 2008, we did not engage in the purchase of any of our own shares.

ITEM 16F: CHANGES IN REGISTRANT'S CERTIFYING ACCOUNTANT

Not applicable.

ITEM 16G. CORPORATE GOVERNANCE

Under NASDAQ Marketplace Rule 4350, or Rule 4350, foreign private issuers, such as our company, are permitted to follow certain home country corporate governance practices instead of certain provisions of Rule 4350. A foreign private issuer that elects to follow a home country practice instead of any of such provisions of Rule 4350, must submit to NASDAQ, in advance, a written statement from an independent counsel in such issuer s home country certifying that the issuer s practices are not prohibited by the home country s laws.

On October 23, 2007, we provided NASDAQ with a notice of non-compliance with respect to the requirement to obtain shareholder approval for the establishment or material amendment of certain equity based compensation plans and arrangements, under which shares may be acquired by officers, directors, employees or consultants. Under Israeli law and practice, the approval of the board of directors is required for the establishment or material amendment of such equity based compensation plans and arrangements. However, any equity based compensation arrangement with a director or the material amendment of such an arrangement must be approved by our audit committee, board of directors and shareholders, in that order. We follow Israeli law and practice in accordance with which our board of directors is authorized to recommend to our shareholders director nominees for election, and our shareholders may nominate candidates for election as directors by the general meeting of shareholders. See Item 6C. Directors, Senior Management and Employees Board Practices Election of Directors.

PART III

ITEM 17: FINANCIAL STATEMENTS

Not applicable.

ITEM 18: FINANCIAL STATEMENTS

The Consolidated Financial Statements and related notes required by this item are contained on pages F-1 through F-51 hereof.

Index to Consolidated Financial Statements	PAGE
Management's Report on Internal Control over Financial Reporting	F-2
Reports of Independent Registered Public Accounting Firm	F-3
Consolidated Balance Sheets	F-5
Consolidated Statements of Operations	F-7
Consolidated Statements of Changes in Shareholders' Equity	F-8
Consolidated Statements of Cash Flows	F-9
Notes to Consolidated Financial Statements	F-11

ITEM 19: EXHIBITS

1.1 Memorandum of Association, as amended. Previously filed as Exhibit 1.1 to our Annual Report on Form 20-F for the fiscal year ending December 31, 2000, which Exhibit is incorporated herein by reference.

1.2 Articles of Association, as amended and restated.

2.1 Form of 4.00% Convertible Subordinated Note due 2012. Previously filed as Exhibit T3C to our Registration Statement on Form F-3 (No.333-38667) which Exhibit is incorporated herein by reference

4.1. Sublease and Master Deed of Lease dated as of March 28, 2001 by and among BP III Leasco, LLC as Sublessor, BP Tysons, LLC as Landlord and Spacenet Real Estate Holdings, LLC as Sublessee and Master Tenant. Previously filed as Exhibit 4.7 to our Annual Report on Form 20-F for the fiscal year ending December 31, 2000, which Exhibit is incorporated herein by reference.

8.1 List of subsidiaries. Previously filed as Exhibit 8.1 to our Annual Report on Form 20-F for the fiscal year ending December 31, 2006, which Exhibit is incorporated herein by reference.

10.1 Consent Kost Forer Gabbay & Kasierer, a member of Ernst & Young Global.

12.1 Certification of Chief Executive Officer pursuant to Rule 13a-14(a) under the Securities Exchange Act of 1934, as amended.

12.2 Certification of Chief Financial Officer pursuant to Rule 13a-14(a) under the Securities Exchange Act of 1924, as amended.

13 Certification by Chief Executive Officer and Chief Financial Officer pursuant to section 906 of the Sarbanes-Oxley Act of 2002.

The registrant hereby certifies that it meets all of the requirements for filing on Form 20-F and that it has duly caused and authorized the undersigned to sign this annual report on its behalf.

GILAT SATELLITE NETWORKS LTD.

By: /s/ Amiram Levinberg

Amiram Levinberg
Chairman of the Board of Directors

Date: April 7, 2009

GILAT SATELLITE NETWORKS LTD. AND ITS SUBSIDIARIES

CONSOLIDATED FINANCIAL STATEMENTS

AS OF DECEMBER 31, 2008

IN U.S. DOLLARS

INDEX

	Page
Management's Report on Internal Control Over Financial Reporting	F-2
Reports of Independent Registered Public Accounting Firm	F-3 - F-4
Consolidated Balance Sheets	F-5- F-6
Consolidated Statements of Operations	F-7
Statements of Changes in Shareholders' Equity	F-8
Consolidated Statements of Cash Flows	F-9 - F-10
Notes to Consolidated Financial Statements	F-11- F-53

MANAGEMENT S REPORT ON INTERNAL CONTROL OVER FINANCIAL REPORTING

Gilat s management is responsible for establishing and maintaining adequate internal control over financial reporting for Gilat. Gilat s internal control over financial reporting is a process to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with U.S generally accepted accounting principles. Gilat s internal control over financial reporting includes those policies and procedures that:

pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of Gilat's assets,

provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of Gilat are being made only in accordance with authorizations of management and directors of Gilat, and

provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use or disposition of Gilat s assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projection of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

Gilat s management assessed the effectiveness of its internal control over financial reporting as of December 31, 2008. In conducting its assessment of internal control over financial reporting, management based its evaluation on the framework in Internal Control Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). Gilat s management has concluded based on its assessment, that its internal control over financial reporting was effective as of December 31, 2008 based on these criteria.

The effectiveness of Gilat s internal control over financial reporting as of December 31, 2008, has been audited by Kost, Forer, Gabbay & Kasierer (A Member of Ernst & Young Global), an independent registered public accounting firm.

F - 2

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Board of Directors and Shareholders of

GILAT SATELLITE NETWORKS LTD.

We have audited Gilat Satellite Networks Ltd. s (Gilat) internal control over financial reporting as of December 31, 2008, based on criteria established in Internal Control-Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (the COSO criteria). Gilat s management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting. Our responsibility is to express an opinion on the Company s internal control over financial reporting based on our audit.

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. Our audit included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, testing and evaluating the design and operating effectiveness of internal control based on the assessed risk, and performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion.

A company s internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company s internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company s assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

In our opinion, Gilat maintained, in all material respects, effective internal control over financial reporting as of December 31, 2008, based on the COSO criteria.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated balance sheets of Gilat and its subsidiaries as of December 31, 2008 and 2007, and the related consolidated statements of operations, changes in shareholders equity and cash flows for each of the three years in the period ended December 31, 2008, and our report dated April 7, 2009, expressed an unqualified opinion thereon.

Tel-Aviv, Israel
April 7, 2009

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

F - 3

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Board of Directors and Shareholders of

GILAT SATELLITE NETWORKS LTD.

We have audited the accompanying consolidated balance sheets of Gilat Satellite Networks Ltd. (the Company) and its subsidiaries as of December 31, 2008 and 2007, and the related consolidated statements of operations, changes in shareholders equity and cash flows for each of the three years in the period ended December 31, 2008. These consolidated financial statements are the responsibility of the Company s management. Our responsibility is to express an opinion on these financial statements based on our audits.

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

In our opinion, based on our audits, the consolidated financial statements referred to above present fairly, in all material respects, the consolidated financial position of the Company and its subsidiaries as of December 31, 2008 and 2007, and the consolidated results of their operations and cash flows, for each of the three years in the period ended December 31, 2008, in conformity with U.S. generally accepted accounting principles.

As discussed in Note 2t to the consolidated financial statements, in 2007, the Company adopted Interpretation No.48, Accounting for Uncertainty in Income Taxes, an Interpretation of FASB Statement No. 109".

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the effectiveness of the Company s internal control over financial reporting as of December 31, 2008, based on criteria established in Internal Control-Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission and our report dated April 7, 2009, expressed an unqualified opinion thereon.

Tel-Aviv, Israel
April 7, 2009

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

F - 4

GILAT SATELLITE NETWORKS LTD. AND ITS SUBSIDIARIES

CONSOLIDATED BALANCE SHEETS

U.S. dollars in thousands

	December 31,	
	2008	**2007**
ASSETS		
CURRENT ASSETS:		
Cash and cash equivalents	$ 73,916	$ 122,807
Short- term bank deposits and held-to-maturity marketable securities	63,033	45,578
Short-term restricted cash	8,581	7,091

	December 31,	
Restricted cash held by trustees	24,169	7,450
Trade receivables, net	59,038	43,746
Inventories	20,719	24,794
Other current assets	22,036	24,748
Total current assets	271,492	276,214
LONG-TERM INVESTMENTS AND RECEIVABLES:		
Severance pay funds	11,085	11,835
Long-term restricted cash	5,692	6,321
Long-term restricted cash held by trustees	-	16,544
Long-term trade receivables, receivables in respect of capital leases and other receivables	8,937	9,170
Total long-term investments and receivables	25,714	43,870
PROPERTY AND EQUIPMENT, NET	109,369	105,247
INTANGIBLE ASSETS AND DEFERRED CHARGES, NET	4,064	4,771
Total assets	$ 410,639	$ 430,102

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

GILAT SATELLITE NETWORKS LTD. AND ITS SUBSIDIARIES

CONSOLIDATED BALANCE SHEETS

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

	December 31,	
	2008	**2007**
LIABILITIES AND SHAREHOLDERS' EQUITY		
CURRENT LIABILITIES:		
Short-term bank credit	$ 6,500	$ 5,823
Current maturities of long-term loans	4,346	5,354
Trade payables	23,317	25,954
Accrued expenses	25,761	20,275
Short-term advances from customer, held by trustees	24,169	15,005
Other current liabilities	34,593	52,436

	December 31,	
Total current liabilities	118,686	124,847
LONG-TERM LIABILITIES:		
Long-term loans, net	14,003	18,704
Long-term advances from customer, held by trustees	-	8,989
Accrued severance pay	12,297	11,723
Accrued interest related to restructured debt	1,838	2,493
Convertible subordinated notes	16,315	16,315
Other long-term liabilities	17,276	19,221
Total long-term liabilities	61,729	77,445
COMMITMENTS AND CONTINGENCIES		
SHAREHOLDERS' EQUITY:		
Share capital -		
Ordinary shares of NIS 0.2 par value: Authorized - 60,000,000 shares as of December 31, 2008 and 2007; Issued and outstanding - 40,048,591 and 39,611,873 shares as of December 31, 2008 and 2007, respectively	1,821	1,796
Additional paid-in capital	862,390	859,207
Accumulated other comprehensive income	2,106	1,776
Accumulated deficit	(636,093)	(634,969)
Total shareholders' equity	230,224	227,810
Total liabilities and shareholders' equity	$ 410,639	$ 430,102

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

GILAT SATELLITE NETWORKS LTD. AND ITS SUBSIDIARIES

CONSOLIDATED STATEMENTS OF OPERATIONS

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

	Year ended December 31,		
	2008	**2007**	**2006**
Revenue:			
Products	$ 150,351	$ 156,798	$ 126,093
Services	117,175	125,821	122,617

	Year ended December 31,		
Total revenue	267,526	282,619	248,710
Cost of revenue:			
Products	80,424	82,822	66,363
Services	101,150	97,952	91,982
Total cost of revenue	181,574	180,774	158,345
Gross profit	85,952	101,845	90,365
Operating expenses:			
Research and development costs, net	16,942	15,030	13,642
Selling and marketing expenses	35,783	38,374	36,475
General and administrative expenses	29,819	31,052	26,800
Impairment of long-lived assets and other charges	5,020	12,218	-
Operating income (loss)	(1,612)	5,171	13,448
Financial income (expenses), net	1,300	5,998	(742)
Expenses related to aborted merger transaction	(2,350)	-	-
Other income (loss)	2,983	(116)	138
Income before taxes on income	321	11,053	12,844
Taxes on income	1,445	963	2,357
Net income (loss)	$ (1,124)	$ 10,090	$ 10,487
Net earnings (loss) per share:			
Basic	$ (0.03)	$ 0.26	$ 0.41
Diluted	$ (0.03)	$ 0.24	$ 0.38
Weighted average number of shares used in computing net earnings (loss) per share:			
Basic	39,901,019	39,140,718	25,799,077
Diluted	39,901,019	41,576,454	27,519,726

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

GILAT SATELLITE NETWORKS LTD. AND ITS SUBSIDIARIES

CONSOLIDATED STATEMENTS OF CHANGES IN SHAREHOLDERS' EQUITY

U.S. dollars in thousands

	Number of Ordinary shares (in thousands)	Share capital	Additional paid-in capital	Accumulated other comprehensive income (loss) **)	Accumulated deficit	Total comprehensive income (loss)	Total shareholders' equity
Balance as of December 31 2005	22,556	$ 995	$ 738,724	$ 16	$ (654,237)		$ 85,498
Exercise of stock options	669	30	3,604	-	-		3,634
Stock-based compensation related to employees stock options	-	-	3,757	-	-		3,757
Conversion of long-term convertible loan from a related party	10,578	492	67,619	-	-		68,111
Issuance of shares in a public offering, net of $ 2,755 issuance expenses	5,017	240	39,646	-	-		39,886
Comprehensive income:							
Foreign currency translation adjustments	-	-	-	686		$ 686	686
Net income	-	-	-	-	10,487	10,487	10,487
Total comprehensive income						$ 11,173	
Balance as of December 31, 2006	38,820	1,757	853,350	702	(643,750)		212,059
Exercise of stock options	791	39	4,532	-	-		4,571
Stock-based compensation related to employees stock options	-	-	1,303	-	-		1,303
Conversion of convertible subordinated notes	1	*) -	22	-	-		22
Accumulated affect of adjustment upon adoption of FASB Interpretation No. 48		-	-	-	(1,309)		(1,309)
Comprehensive income:							
Foreign currency translation adjustments	-	-	-	1,074	-	$ 1,074	1,074
Net income	-	-	-	-	10,090	10,090	10,090
Total comprehensive income						$ 11,164	
Balance as of December 31, 2007	39,612	1,796	859,207	1,776	(634,969)		227,810
Exercise of stock options	437	25	2,491	-	-	-	2,516
Stock-based compensation related to employees stock options	-	-	692	-	-	-	692
Comprehensive loss:							
Foreign currency translation adjustments	-	-	-	(766)	-	(766)	(766)
Unrealized gain on forward contracts, net	-	-	-	1,096	-	$ 1,096	1,096
Net loss	-	-	-	-	(1,124)	(1,124)	(1,124)
Total comprehensive loss						$ (794)	
Balance as of December 31, 2008	40,049	$ 1,821	$ 862,390	$ 2,106	$ (636,093)		$ 230,224

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

*) represents an amount of less the one thousand dollars.

**) represents adjustments in respect of foreign currency translation and unrealized gain on forward contracts, net. Balance of accumulated other comprehensive income (loss) as of December 31, 2008, 2007 and 2006 included foreign currency translation adjustments in the amount of $ 1,010, $ 1,776 and $ 702, respectively, and unrealized gain on forward contracts, net, in the amount of $ 1,096, $ 0, $ 0, respectively.

GILAT SATELLITE NETWORKS LTD. AND ITS SUBSIDIARIES

CONSOLIDATED STATEMENTS OF CASH FLOWS

U.S. dollars in thousands

	Year ended December 31,		
	2008	**2007**	**2006**
Cash flows from operating activities:			
Net income (loss)	$ (1,124)	$ 10,090	$ 10,487
Adjustments required to reconcile net income (loss) to net cash provided by (used in) operating activities:			
Depreciation and amortization	13,132	17,715	20,728
Impairment of long-lived assets and other charges	5,020	12,218	-
Gain from disposal of a subsidiary consolidated in previous years	-	-	(137)
Stock based compensation related to employees stock options	692	1,303	3,757
Accretion of discount related to the York loan	-	-	504
Accrued severance pay, net	1,324	(218)	177
Accrued interest on short and long-term restricted cash	(189)	(1,326)	(896)
Accrued interest on held-to-maturity marketable securities	(1,778)	(2,102)	-
Exchange rate differences on long-term loans	(348)	766	705
Exchange rate differences on loans to employees	28	(250)	(223)
Capital loss from disposal of property and equipment	89	167	57
Deferred income taxes	(265)	(891)	(1,131)
Decrease (increase) in trade receivables, net	(15,979)	(14,037)	4,120
Decrease (increase) in other assets (including short-term, long-term and deferred charges)	(4,336)	28,529	(6,258)
Decrease (increase) in inventories	36	(207)	(11,846)
Increase (decrease) in trade payables	(3,185)	4,619	(3,000)
Increase (decrease) in accrued expenses	3,640	(1,455)	(1,049)
Increase (decrease) in advances from customer, held by trustees, net	176	(7,914)	(11,430)
Increase (decrease) in other accounts payable and other long-term liabilities, mainly deferred revenue	(16,553)	(24,232)	33,259
Net cash provided by (used in) operating activities	(19,620)	22,775	37,824
Cash flows from investing activities:			
Purchase of property and equipment	(13,799)	(9,269)	(6,519)
Other investments	(195)	(223)	(6)
Purchase of held-to-maturity marketable securities	(143,572)	(73,791)	-
Proceeds from held-to-maturity marketable securities	127,895	30,315	-
Proceeds from sale of an investment accounted for at cost	1,801	-	-
Disposal of a subsidiary consolidated in previous periods	-	-	137
Proceeds from short-term bank deposits	-	-	3,300

	Year ended December 31,		
Proceeds from sale of property and equipment	426	33	1,577
Loans to employees, net	2,798	946	284
Investment in restricted cash (including long-term)	(1,630)	(6,196)	(5,191)
Proceeds from restricted cash (including long-term)	769	4,259	16,263
Investment in restricted cash held by trustees	-	-	(3,520)
Proceeds from restricted cash held by trustees	-	90	1,987
Net cash provided by (used in) investing activities	$ (25,507)	$ (53,836)	$ 8,312

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

F - 9

GILAT SATELLITE NETWORKS LTD. AND ITS SUBSIDIARIES

CONSOLIDATED STATEMENTS OF CASH FLOWS

U.S. dollars in thousands

	Year ended December 31,		
	2008	**2007**	**2006**
Cash flows from financing activities:			
Exercise of stock options	$ 2,516	$ 4,571	$ 3,634
Issuance of shares, net of issuance expenses	-	(324)	40,210
Short-term bank credit, net	678	4,623	(6,972)
Proceeds from long-term loans	-	1,000	-
Repayments of long-term loans	(5,362)	(6,563)	(8,703)
Net cash provided by (used in) financing activities	(2,168)	3,307	28,169
Effect of exchange rate changes on cash and cash equivalents	(1,596)	1,016	311
Increase (decrease) in cash and cash equivalents	(48,891)	(26,738)	74,616
Cash and cash equivalents at the beginning of the year	122,807	149,545	74,929
Cash and cash equivalents at the end of the year	$ 73,916	$ 122,807	$ 149,545
Supplementary cash flow activities:			
(1) Cash paid during the year for:			
Interest	$ 2,160	$ 2,817	$ 7,769

	Year ended December 31,		
Income taxes	$ 1,180	$ 1,898	$ 787

(2) Non-cash transactions:

Conversion of long-term convertible loan from a related party	$ -	$ -	$ 68,111
Classification between property and equipment and inventories - net	$ 3,421	$ 2,197	$ 8,823
Purchase of property and equipment by assumption of loan	$ -	$ -	$ 1,753
Issuance expenses payable	$ -	$ -	$ 324

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

F - 10

GILAT SATELLITE NETWORKS LTD. AND ITS SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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

NOTE 1: GENERAL

a. Organization:

Gilat Satellite Networks Ltd. (the Company or Gilat) and its subsidiaries (the Group) is a global provider of Internet Protocol, or IP, based digital satellite communication and networking products and services. The Company designs, produces and markets VSATs, or very small aperture terminals, and related VSAT network equipment. VSATs are earth based terminals that transmit and receive broadband, Internet, voice, data and video via satellite. VSAT networks combine a large central earth station, called a hub, with multiple remote sites (ranging from tens to thousands of sites), which communicate via satellite.

The Company currently operates three complementary, vertically integrated operational segments:

Gilat Network Systems (GNS) provides VSAT-based networks and associated professional services, including turnkey and management services, to telecom operators worldwide.

Spacenet Inc. (Spacenet) provides satellite network services to enterprises, small office/home office (SOHOs) and residential customers in the U.S.

Spacenet Rural Communications (SRC) provides telephony, Internet and data services primarily for rural communities in emerging markets in Latin America under projects that are subsidized by government entities.

Gilat was incorporated in Israel in 1987 and launched its first generation VSAT in 1989. For a description of principal markets and customers, see note 15.

b. Impairment of long-lived assets and other charges:

In 2008 and 2007, the Group recorded losses for the impairment of its long lived assets and other charges with respect to its Colombian activity, included in SRC segment, in the amounts of $ 5,020 and $ 12,218, respectively, see also note 11.

c. Agreement and Plan of Merger (the Agreement and Plan of Merger):

On March 31, 2008 the Company announced the signing of an Agreement and Plan of Merger to be acquired for an aggregate value of $ 475,000 in an all cash transaction by a consortium of private equity investors. The closing of the transaction was subject to shareholders approval, certain regulatory approvals and other customary closing conditions.

On August 5, 2008 the Company informed the consortium that all conditions precedent to closing had been met.

On August 29, 2008 the Company notified the consortium that it was terminating the Agreement and Plan of Merger citing the consortium s intentional breach of the merger agreement and failure to close the merger transaction within the extended time period established to complete the transaction.

The definitive agreement provides for a termination fee in the amount of approximately $47,500 payable to the Company, and the Company has sued the consortium members for this amount. See also note 7e.

NOTE 1: GENERAL (Cont.)

d. York Capital Management LP (York):

In July 2005, Bank Hapoalim, an Israeli bank, assigned its loan to the Company to York. The loan included the right to convert the aggregate amount of the loan plus accrued interest into the Company s ordinary shares. At that time, Bank Hapoalim also provided York with an option to purchase 1,000,809 of the Company s shares held by it at $ 6.30 per share for a period of two years. In addition, York was given a proxy to vote all 2,052,428 ordinary shares of the Company owned by Bank Hapoalim and an additional 1,250,000 ordinary shares of the Company owned by Mivtach Shamir Finance Ltd. until July 18, 2007. Following the above, York became a related party of the Company.

In December 2005, the Company revised the terms of the loan that was assigned by Bank Hapoalim to York. Under the amendment, York agreed to defer $ 19,350 of principal payments due and established a new payment schedule. In consideration, the Company agreed to reduce the exercise price of the warrant issuable to York (assigned by Bank Hapoalim) to $ 6.75 per share for the period ending September 30, 2006. In addition, during that period, the Company was granted the right to require the conversion of the outstanding loan from York at $ 6.75 per share under certain circumstances. Beginning October 1, 2006, the exercise price of the warrant was to revert to the original terms (see also Note 10).

On September 27, 2006, York converted its entire loan and accrued interest into warrants and immediately exercised its option to convert the warrants into shares at $ 6.75 per share. This resulted in the issuance of 10,578,474 ordinary shares of the Company to York.

Based on Interpretation 1 of Opinion 26 and EITF No. 85-17, Accrued Interest upon Conversion of Convertible Debt , the net carrying amount of the convertible debt and accrued interest unpaid, including the unamortized discount, in the total amount of $ 68,111 was credited to shareholders equity upon conversion.

e. Issuance of ordinary shares

In December, 2006, the Company consummated a public offering of 8,050,000 of its ordinary shares at a price of $8.50 per share. Of such shares, 5,016,667 ordinary shares were sold by the Company and the remaining shares were sold by York. See also Note 9.

NOTE 2: SIGNIFICANT ACCOUNTING POLICIES

The consolidated financial statements have been prepared in accordance with generally accepted accounting principles in the United States (U.S. GAAP).

a. Use of estimates:

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

NOTE 2: SIGNIFICANT ACCOUNTING POLICIES (Cont.)

b. Functional Currency:

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

Accordingly, monetary accounts maintained in currencies other than the dollar are remeasured into dollars in accordance with SFAS No. 52 Foreign Currency Translation . All transaction gains and losses of the remeasurement of monetary balance sheet items are reflected in the consolidated statements of operations as financial income or expenses, as appropriate.

The financial statements of foreign subsidiaries, whose functional currency has been determined to be their local currency, have been translated into dollars. Assets and liabilities have been translated using the exchange rates in effect at the balance sheet date. Statements of operations amounts have been translated using average rates, which approximates the prevailing exchange rate for each transaction. The resulting translation adjustments are reported as a component of shareholders equity in accumulated other comprehensive income (loss).

c. Principles of consolidation:

The consolidated financial statements include the accounts of the Company and its wholly owned subsidiaries. Intercompany balances and transactions, including profits from intercompany sales not yet realized outside the Group, have been eliminated upon consolidation.

d. Cash equivalents:

Cash equivalents are short-term highly liquid investments that are not restricted as to withdrawals or use with maturities of three months or less at the date acquired.

e. Marketable securities:

The Company accounts for investments in marketable debt securities in accordance with Statement of Financial Accounting Standard No. 115, Accounting for Certain Investments in Debt and Equity Securities (SFAS No. 115). Management determines the appropriate classification of its investments in debt and equity securities at the time of purchase and reevaluates such determinations at each balance sheet date.

As of December 31, 2008 and 2007, the Company classified all of its debt securities as held-to-maturity. Debt securities are classified as held-to-maturity when the Company has the positive intent and ability to hold the securities to maturity and are stated at amortized cost. The cost of held-to-maturity securities is adjusted for amortization of accretion of discounts to maturity. Interest is included in financial income (expenses), net.

F - 13

GILAT SATELLITE NETWORKS LTD. AND ITS SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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

NOTE 2: SIGNIFICANT ACCOUNTING POLICIES (Cont.)

In accordance with the Company s policy and FASB Staff Position (FSP) Nos. SFAS 115-1 (FSP 115-1) and SFAS 124-1, The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments , the Company recognizes an impairment charge when a decline in the fair value of its investments below the cost basis is judged to be other-than- temporary. The Company considers various factors in determining whether to recognize an impairment charge, including the Company s intent and ability to hold the investment for a period of time sufficient to allow for any anticipated recovery in market value, the length of time and extent to which the fair value has been less than the cost basis, the credit ratings of the securities and the financial condition and near-term prospects of the issuers. During the years 2008 and 2007, the Company did not record any other-than-temporary impairment losses with respect to its holdings of marketable debt securities.

f. Short-term and long-term restricted cash:

Short-term restricted cash is primarily invested in certificates of deposit, which mature within one year. As of December 31, 2008, the vast majority of this amount was linked to the dollar. It is used as collateral for the lease of the Group s offices, performance guarantees to customers and loans, and bears a weighted average interest of 3.01% and 5.43% in 2008 and 2007, respectively.

Long-term restricted cash is primarily invested in certificates of deposit, which mature in more than one year. As of December 31, 2008, the vast majority of the amount is linked to the dollar. It bears an annual weighted average interest rate of 0.64% and 4.46% as of December 31, 2008 and 2007, respectively. This long-term restricted cash is used as collateral for the lease of the Group s offices, a sale and lease back transaction, performance guarantees to customers and loans.

g. Restricted cash held by trustees:

Short-term and long term restricted cash held by trustees is primarily invested in certificates of deposits and US government securities. As of December 31, 2008, 80% of the total amount is linked to the dollar and 20% of the total amount is linked to the Colombian Peso. The amounts held by trustees bear interest at rates of 2% and 10%, respectively, and are released based upon performance milestones as stipulated in the Group s agreements with the government of Colombia. The Group signed revised agreements with the government of Colombia effective December 26, 2008. See also note 11.

h. Inventories:

Inventories are stated at the lower of cost or market value. Inventory write-offs are provided to cover risks arising from slow-moving items, excess inventories, discontinued products, new products introduction and for market prices lower than cost. Any write-off is recognized in the consolidated statement of operations as cost of revenue.

Cost is determined as follows:

Raw materials, parts and supplies with the addition of allocable indirect manufacturing costs using the average cost method.

Work-in-progress represents the cost of manufacturing with the addition of allocable indirect manufacturing costs, using the average cost method.

NOTE 2: SIGNIFICANT ACCOUNTING POLICIES (Cont.)

Finished products calculated on the basis of direct manufacturing costs with the addition of allocable indirect manufacturing costs, using the average cost method.

i. Investment in other companies:

The investment in these companies is stated at cost since the Group does not have the ability to exercise significant influence over operating and financial policies of the investments.

The Group s investments in other companies are reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of an investment may not be recoverable in accordance with APB 18. Any impairment loss is recognized in the consolidated statements of operations. As of December 31, 2008, 2007 and 2006, the investment in these companies was nil.

j. Long-term trade receivables:

Long-term trade receivables from long-term payment agreements are initially recognized at estimated present values determined based on current rates of interest and reported at the net amounts in the accompanying consolidated financial statements. Imputed interest is recognized, using the effective interest method, as a component of financial income (expenses) in the statements of operations.

k. Property and equipment, net:

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

	Years
Buildings	50
Computers, software and electronic equipment	3 - 5
Office furniture and equipment	5 - 17
Vehicles	5 - 7
Leasehold improvements	Over the term of the lease or the useful life of the improvements, the shorter of.

Equipment leased to others under operating leases is carried at cost less accumulated depreciation and depreciated using the straight-line method over the useful life of the assets.

l. Intangible assets and deferred charges:

Intangible assets with definite useful life are subject to amortization and are carried at cost less accumulated amortization.

The assets are amortized using the straight-line method over their estimated useful lives, which are five to fifteen years, in accordance with Statement of Financial Accounting Standards No. 142, Goodwill and Other Intangible Assets .

NOTE 2: SIGNIFICANT ACCOUNTING POLICIES (Cont.)

Deferred charges represent costs related to the deferred revenue. Such costs are recognized when the related revenues are recognized and are presented on the balance sheet under other current assets for deferred charges that will be recognized within a year after the balance sheet date and under intangible assets and deferred charges, for deferred charges that will be recognized in more than one year after the balance sheet date.

m. Impairment of long-lived assets and long-lived assets to be disposed of:

The Group s long-lived assets are reviewed for impairment in accordance with SFAS 144 Accounting for the Impairment or Disposal of Long-Lived Assets , whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. Recoverability of assets to be held and used is measured by a comparison of the carrying amount of an asset to the future undiscounted cash flows expected to be generated by the assets. Such measurement includes significant estimates. If such assets are considered to be impaired, the impairment to be recognized is measured by the amount by which the carrying amount of the assets exceeds the fair value of the assets. However, the carrying amount of a group of assets is not to be reduced below its fair value. Assets to be disposed of are reported at the lower of the carrying amount or fair value less costs to sell.

In 2008 and 2007, the Group recorded impairment losses in respect of long lived assets related to its SRC operational segment in Colombia. See also Note 11.

n. Revenue recognition:

The Group generates revenue mainly from the sale of products and services for satellite-based communications networks. Sale of products includes mainly the sale of VSATs and hubs. Service revenue include access to and communication via satellites (space segment), installation of network equipment, telephone services, internet services, consulting, on-line network monitoring, network maintenance and repair services. The Group sells its products primarily through its direct sales force and indirectly through resellers. Sales consummated by the Group s sales force and sales to resellers are considered sales to end-users.

Revenue from product sales are recognized in accordance with SEC Staff Accounting Bulletin (SAB) No. 104, Revenue Recognition (SAB No. 104), when delivery has occurred, persuasive evidence of an agreement exists, the vendor s fee is fixed or determinable, no further obligation exists and collectability is probable. When significant acceptance provisions are included in the arrangement revenue are deferred until the acceptance occurs. Generally the Group does not grant rights of return. Service revenue are recognized ratably over the period of the contract or as services are performed, as applicable.

In accordance with Emerging Issues Task Force (EITF) Issue No. 00-21, Revenue Arrangements with Multiple Deliverables (EITF 00-21) a multiple-element arrangement (an arrangement that involves the delivery or performance of multiple products, services and/or rights to use assets) is separated into more than one unit of accounting, if the functionality of the delivered element(s) is not dependent on the undelivered element(s), there is vendor-specific objective evidence (VSOE) of fair value of the undelivered element(s) and delivery of the delivered element(s) represents the culmination of the earnings process for those element(s). If these criteria are not met, the revenue is deferred until such criteria are met or until the period in which the last undelivered element is delivered. If there is VSOE for all units of accounting in an arrangement, the arrangement consideration is allocated to the separate units of accounting based on each unit s relative VSOE.

F - 16

GILAT SATELLITE NETWORKS LTD. AND ITS SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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

NOTE 2: SIGNIFICANT ACCOUNTING POLICIES (Cont.)

Revenue from products under sales-type-lease contracts are recognized in accordance with SFAS No. 13, Accounting for Leases (SFAS No. 13) upon installation or upon delivery, in cases where the customer obtains its own or other s installation services. The net investments in sales-type-leases are discounted at the interest rates implicit in the leases. The present values of payments due under sales-type-lease contracts are recorded as revenue at the time of shipment or installation, as appropriate. Future interest income is deferred and recognized over the related lease term as financial income.

Revenue from products and services under operating leases of equipment are recognized ratably over the lease period, in accordance with SFAS No. 13.

Deferred revenue represent amounts received by the Company when the criteria for revenue recognition as described above are not met and are included in other current liabilities and other long term liabilities . In general, when deferred revenue are recognized as revenue, the associated deferred costs are also recognized as cost of sales.

o. Shipping and advertising expenses:

Selling and marketing expenses include shipping expenses in the amounts of $ 2,102, $ 2,450, and $ 3,800 for the years ended December 31, 2008, 2007 and 2006, respectively.

Advertising costs are expensed as incurred. Advertising expenses for the years ended December 31, 2008, 2007 and 2006 amounted to $ 878, $ 897 and $ 562, respectively.

p. Warranty costs:

Generally, the Company provides product warranties for periods between twelve to eighteen months at no extra charge. A provision is recorded for estimated warranty costs based on the Company s experience. Warranty expenses for the years ended December 31, 2008, 2007 and 2006 were immaterial.

q. Research and development expenses:

Research and development expenses, net of grants received, are charged to expenses as incurred.

r. Grants:

The Company received non-royalty-bearing grants from the Government of Israel, the Advanced Satellite Network Technologies (ASNT), SES Global S.A Satellite Networks Next Generation Technologies and from other funding sources, for approved research and development projects. These grants are recognized at the time the Company is entitled to such grants on the basis of the costs incurred or milestones achieved as provided by the relevant agreement and included as a deduction from research and development expenses.

Research and development grants deducted from research and development expenses amounted to $ 1,760, $ 2,240 and $ 2,045 in 2008, 2007 and 2006, respectively.

F - 17

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

NOTE 2: SIGNIFICANT ACCOUNTING POLICIES (Cont.)

s. Accounting for stock-based compensation:

The Company accounts for stock-based compensation in accordance with SFAS No. 123 (revised 2004), Stock-Based Payment (SFAS No. 123(R)). SFAS No. 123(R) requires companies to estimate the fair value of equity-based payment awards on the date of grant using an option-pricing model. The value of the portion of the award that is ultimately expected to vest is recognized as an expense over the requisite service periods in the Company s consolidated statement of operations.

The Company recognizes compensation expenses for the value of its awards, which vested and were granted prior to January 1, 2006, based on the accelerated attribution method and for awards granted subsequent to January 1, 2006, based on the straight line method over the requisite service period of each of the awards, net of estimated forfeitures. SFAS No. 123(R) requires forfeitures to be estimated at the time of grant and revised, if necessary, in subsequent periods if actual forfeitures differ from those estimates.

The Company selected the Black-Scholes-Merton option pricing model as the most appropriate fair value method for its stock-options awards and values restricted stock based on the market value of the underlying shares at the date of grant. The option-pricing model requires a number of assumptions, of which the most significant are the expected stock price volatility and the expected option term. Expected volatility was calculated based upon actual historical stock price movements. The expected term of options granted is based upon historical experience and represents the period of time that options granted are expected to be outstanding. Prior to December 31, 2007 expected term of options was determined based on simplified method permitted by SAB No. 107 as the average of the vesting period and the contractual term. Starting January 1, 2008 expected term of options granted is based upon historical experience complying with SAB 110. The risk-free interest rate is based on the yield from U.S. treasury bonds with an equivalent term. The Company has historically not paid dividends and has no foreseeable plans to pay dividends.

The Company accounts for equity instruments issued to third party service providers (non-employees) in accordance with the fair value based on an option-pricing model, pursuant to the guidance in EITF 96-18 Accounting for Equity Instruments That Are Issued to Other Than Employees for Acquiring, or in Conjunction with Selling Goods or Services . The fair value of the options granted is revalued over the related service periods and recognized over the vesting period.

See Note 9 for a further discussion on stock-based compensation.

t. Income taxes:

The Group accounts for income taxes in accordance with SFAS No. 109, Accounting for Income Taxes . SFAS 109 prescribes the use of the liability method whereby deferred tax assets and liability account balances are determined based on differences between the financial reporting and the tax basis of assets and liabilities and are measured using the enacted tax rates and laws that will be in effect when the differences are expected to reverse. The Group provides a valuation allowance, if necessary, to reduce deferred tax assets to their estimated realizable value, if it is more likely than not that a portion or all of the deferred tax assets will not be realized.

GILAT SATELLITE NETWORKS LTD. AND ITS SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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

NOTE 2: SIGNIFICANT ACCOUNTING POLICIES (Cont.)

In July 2006, the FASB issued FASB Interpretation No. 48, Accounting for Uncertainty in Income Taxes, an Interpretation of FASB Statement No. 109 (FIN 48). FIN 48 clarifies the accounting for income taxes by prescribing the minimum recognition threshold a tax position is required to meet before being recognized in the financial statements. FIN 48 utilizes a two-step approach for evaluating tax positions. Recognition (step one) occurs when an enterprise concludes that a tax position, based solely on its technical merits, is more-likely-than-not to be sustained upon examination. Measurement (step two) is only addressed if step one has been satisfied (i.e., the position is more-likely-than-not to be sustained) otherwise a full liability in respect of a tax position not meeting the more-than-likely-than-not criteria is recognized.

Under step two, the tax benefit is measured as the largest amount of benefit, determined on a cumulative probability basis, that is more-likely-than-not to be realized upon ultimate settlement.

FIN 48 applies to all tax positions related to income taxes subject to FAS 109. This includes tax positions considered to be routine as well as those with a high degree of uncertainty. FIN 48 has expanded disclosure requirements, which include a tabular roll forward of the beginning and ending aggregate unrecognized tax benefits as well as specific detail related to tax uncertainties for which it is reasonably possible the amount of unrecognized tax benefit will significantly increase or decrease within twelve months (See also Note 12).

FIN 48 is effective for fiscal years beginning after December 15, 2006. The cumulative effect of applying FIN 48 is reported as an adjustment to the opening balance of accumulated deficit. The adoption of FIN 48 resulted in an increase of the tax provision in the amount of $ 1,309 which adjusted the balance of the accumulated deficit, as of January 1, 2007.

u. Concentrations of credit risks:

Financial instruments that potentially subject the Group to concentrations of credit risk consist principally of cash and cash equivalents, short-term bank deposits and held-to-maturity marketable securities, short-term and long-term restricted cash, short-term and long-term restricted cash held by trustees, trade receivables, short-term and long-term receivables relating to capital leases and long-term trade receivables.

The majority of the Group s cash and cash equivalents, short-term bank deposits, and short-term and long-term restricted cash are invested in U.S dollars with major banks in Israel and in the United States. Such deposits in the United States may be in excess of insured limits and are not insured in other jurisdictions. Generally, these cash equivalents may be redeemed upon demand and, therefore management believes that they bear lower risk.

Most of the Company s marketable securities include investments in U.S. government debentures. The Company s investment policy, limits the amount the Company may invest in any one type of investment, thereby reducing credit risk concentration. See also Note 3.

The Group also has restricted cash held by trustees, which is invested in U.S. dollar deposits, US government securities and in Colombian Peso deposits with major banks in Colombia and in the U.S. As of December 31, 2008, restricted cash held by the trustees amounted to $ 24,169. The Company is entitled to receive the restricted cash held by the trustee in stages based upon operational milestones. The cash held in trusts is reflected in the Company s balance sheet as Restricted cash held by trustees . If the Company will not meet certain milestones, as determined in the re-negotiated agreements effective on December 26, 2008 with the Colombian government, the Company may be unable to receive this restricted cash. See also Note 11.

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

NOTE 2: SIGNIFICANT ACCOUNTING POLICIES (Cont.)

Trade receivables, short-term and long-term receivables relating to capital leases and long-term trade receivables of the Group are mainly derived from sales to major customers located in the U.S., Europe, Asia, South America and Africa. The Group performs ongoing credit evaluations of its customers and obtains letters of credit and bank guarantees for certain receivables. An allowance for doubtful accounts is determined with respect to specific debts that the Group has determined to be doubtful of collection.

A significant portion of the Group s restricted cash held by trustees, trade receivables and long-term trade receivables is from two countries in Latin America Colombia and Peru. Any instability in the political or economic situation or otherwise in those countries, could have a significant adverse impact on the Company.

In 2008 the Company entered into hedging agreements, with major banks in Israel, in order to hedge portions of its anticipated NIS payroll payments. These contracts are designated as cash flow hedges. Those contracts mature at the time in which the related salary payments are paid. See also note 2(y) and note 8.

v. Employee related benefits:

Severance Pay

The Company s liability for severance pay is calculated pursuant to Israeli severance pay law based on the most recent salary of the employees multiplied by the number of years of employment, as of the balance sheet date. Employees whose employment is terminated by the Company or who are otherwise entitled to severance pay in accordance with Israeli law or labor agreements are entitled to one month s salary for each year of employment or a portion thereof. The Company s liability for all of its Israeli employees is partly provided for by monthly deposits for insurance policies and the remainder by an accrual. The value of these policies is recorded as an asset in the Company s consolidated balance sheet.

During April and May 2008 (the transition date), the Company amended the contracts of most of its Israeli employees so that starting on the transition date, such employees are subject to Section 14 of the Severance Pay Law 1963 (Section 14) for severance pay accumulated in periods of employment subsequent to the transition date. In accordance with section 14, upon termination, the release of the contributed amounts from the fund to the employee shall relieve the Company from any further severance liability and no additional payments shall be made by the Company to the employee. As a result, the related obligation and amounts deposited on behalf of such obligation are not stated on the balance sheet, as the Company is legally released from severance obligation to employees once the amounts have been deposited, and the Company has no further legal ownership of the amounts deposited.

The carrying value for the deposited funds for the Company s employees severance pay for employment periods prior to April and May 2008 include profits and losses accumulated up to the balance sheet date. The deposited funds may be withdrawn only upon the fulfillment of the obligation pursuant to Israeli severance pay law or labor agreements.

NOTE 2: SIGNIFICANT ACCOUNTING POLICIES (Cont.)

Severance pay expenses for the years ended December 31, 2008, 2007 and 2006, amounted to approximately $ 3,265 $ 2,505 and $ 2,421, respectively.

401K profit sharing plans

The Company has a number of savings plans in the United States that qualify under Section 401(k) of the Internal Revenue Code. U.S employees may contribute up to 100% of their pretax salary, but not more than statutory limits. The Company contributes one dollar for each dollar a participant contributes in this plan, in an amount of up to 3% and in addition, it contributes fifty cents for each dollar a participant contributes in this plan, for an additional 3%. Matching contributions in 2008, 2007 and 2006 for all the plans were approximately $ 700 per year. Matching contributions are invested in proportion to each participant s voluntary contributions in the investment options provided under the plan.

w. Fair value of financial instruments:

The following methods and assumptions were used by the Group in estimating their fair value disclosures for financial instruments:

The carrying amounts of cash and cash equivalents, short-term restricted cash, restricted cash held by trustees, trade receivables, short-term bank credit and trade payables approximate their fair value due to the short-term maturity of such instruments.

The carrying amounts of the Group s long-term borrowing arrangements, long-term trade receivables and long-term restricted cash approximate their fair value. The fair value was estimated using discounted cash flow analysis, based on the Group s incremental borrowing rates for similar borrowing or investing arrangements.

The fair value of the convertible subordinated notes was determined based on management estimates that incorporate the estimated market participant expectations of future cash flow and market value (on the over the counter market). As of December 31, 2008 and 2007, the Company s convertible subordinated notes fair value was $13,317 and $13,215, respectively.

x. Net earnings (loss) per share:

Basic net earnings (loss) per share are computed based on the weighted average number of ordinary shares outstanding during each period. Diluted net earnings (loss) per share are computed based on the weighted average number of ordinary shares outstanding during each period, plus dilutive potential ordinary shares considered outstanding during the period, in accordance with SFAS No. 128, Earnings per Share . The total weighted average number of shares related to the outstanding options and warrants excluded from the calculations of diluted net earnings (loss) per share, as they would have been anti-dilutive, was 1,145,918, 272,803 and 9,276,286 for the years ended December 31, 2008, 2007 and 2006, respectively.

NOTE 2: SIGNIFICANT ACCOUNTING POLICIES (Cont.)

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

1. Numerator:

	Year ended December 31,		
	2008	**2007**	**2006**
Numerator for basic and diluted net earnings (loss) per share - Net income (loss) available to holders of Ordinary Shares	$ (1,124)	$ 10,090	$ 10,487

	Year ended December 31,		

2. Denominator (in thousands):

	Year ended December 31,		
	2008	2007	2006
Denominator for basic net earnings (loss) per share -			
Weighted average number of shares	39,901	39,141	25,799
Add-employee stock options and convertible notes	*-	2,435	1,721
Denominator for diluted net earnings (loss) per share - adjusted weighted average shares assuming exercise of options	39,901	41,576	27,520

*Anti-dilutive

y. Derivatives and hedging activities:

Financial Accounting Standard Board Statement No. 133 Accounting for Derivative Instruments and Hedging Activities (SFAS No. 133), as amended, requires the Company to recognize all derivatives on the balance sheet at fair value. Derivatives that are not hedges must be adjusted to fair value through income. If the derivative is a hedge, depending on the nature of the hedge, changes in the fair value of derivatives are either offset against the change in fair value of the hedged assets, liabilities, or firm commitments through earnings or recognized in other comprehensive income until the hedged item is recognized in earnings. The ineffective portion of a derivative s change in fair value is immediately recognized in earnings. The Company uses derivatives to hedge certain cash flow foreign currency exposures in order to further reduce the Company s exposure to foreign currency risks.

NOTE 2: SIGNIFICANT ACCOUNTING POLICIES (Cont.)

z. Impact of recently issued accounting pronouncements:

In February 2008, the FASB issued FASB Staff Position ("FSP") FAS No. 157-2, "Effective Date of FASB Statement No. 157" ("FSP 157-2"), to delay the effective date of FASB Statement 157 for one year for certain nonfinancial assets and nonfinancial liabilities, excluding those that are recognized or disclosed in financial statements at fair value on a recurring basis (that is, at least annually). For purposes of applying the FSP 157-2, nonfinancial assets and nonfinancial liabilities include all assets and liabilities other than those meeting the definition of a financial asset or a financial liability in FASB Statement 159. FSP 157-2 defers the effective date of Statement 157 to fiscal years beginning after November 15, 2008, and interim periods within those fiscal years for items within the scope of this FSP 157-2. The Company does not expect the adoption of FSP 157-2 to have a material impact on its financial position, results of operations or cash flows.

In March 2008, the FASB issued Statement 161 "Disclosures about Derivative Instruments and Hedging Activities" ("SFAS 161") an amendment to FASB No. 133. This statement changes the disclosure requirements for derivative instruments and hedging activities. Entities are required to provide enhanced disclosures about (a) how and why and entity uses derivative instruments, (b) how derivative instruments and related hedged items are accounted for under Statement 133 and its related interpretations, and (c) how derivative instruments and related hedged items affect an entity's financial position, financial performance, and cash flows. This statement is effective for financial statements issued for fiscal years and interim periods beginning after November 15, 2008. Early application is encouraged. The Company does not expect the adoption of SFAS 161 to have a material impact on its financial position, results of operations or cash flows.

In December 2007, the FASB issued SFAS 160, "Noncontrolling Interests in Consolidated Financial Statements" ("SFAS 160 "). SFAS 160 amends ARB 51, "Consolidated Financial Statements ", to establish accounting and reporting standards for the noncontrolling interest in a subsidiary and for the deconsolidation of a subsidiary. It also clarifies that a noncontrolling interest in a subsidiary is an ownership interest in the consolidated entity that should be reported as equity in the consolidated financial statements. SFAS 160 also changes the way the consolidated income statement is presented by requiring consolidated net income to be reported at amounts that include the amounts attributable to both the parent and the noncontrolling interest. It also requires disclosure, on the face of the consolidated statement of income, of the amounts of consolidated net income attributable to the parent and to the noncontrolling interest. SFAS 160 requires that a parent recognize a gain or loss in net income when a subsidiary is deconsolidated and requires expanded disclosures in the consolidated financial statements that clearly identify and distinguish between the interests of the parent owners and the interests of the non-controlling owners of a subsidiary. SFAS 160 is effective for fiscal periods, and interim periods within those fiscal years, beginning on or after December 15, 2008. The impact of SFAS 160 on the Company's consolidated financial statements will depend on the nature and size of acquisitions, if any, subsequent to the effective date.

NOTE 2: SIGNIFICANT ACCOUNTING POLICIES (Cont.)

In December 2007, the FASB issued SFAS 141(R), "Business Combinations" ("SFAS 141(R) "). This Statement replaces SFAS No. 141, "Business Combinations ", and requires an acquirer to recognize the assets acquired, the liabilities assumed, including those arising from contractual contingencies, any contingent consideration and any non-controlling interest in the acquiree at the acquisition date, measured at their fair values as of that date, with limited exceptions specified in the statement. SFAS 141(R) also requires the acquirer in a business combination achieved in stages (sometimes referred to as a step acquisition) to recognize the identifiable assets and liabilities, as well as the non-controlling interest in the acquiree, at the full amounts of their fair values (or other amounts determined in accordance with SFAS 141(R)). In addition, SFAS 141(R)'s requirement to measure the non-controlling interest in the acquiree at fair value will result in recognizing the goodwill attributable to the non-controlling interest in addition to that attributable to the acquirer. SFAS 141(R) applies prospectively to business combinations for which the acquisition date is on or after the beginning of the first annual reporting period beginning on or after December 15, 2008. The impact of SFAS 141R on the Company's consolidated results of operations and financial condition will depend on the nature and size of acquisitions, if any, subsequent to the effective date.

In April 2008, the FASB issued FSP 142-3, "Determination of the Useful Life of Intangible Assets" (FSP 142-3). FSP 142-3 amends the factors that should be considered in developing renewal or extension assumptions used to determine the useful life of a recognized intangible asset under SFAS No. 142, "Goodwill and Other Intangible Assets". FSP 142-3 is effective for fiscal years beginning after December 15, 2008. The Company is currently evaluating the potential impact, if any, of the adoption of FAS 142-3 on its consolidated financial statement

EITF Issue No. 08-7, "Defensive Intangible Assets" ("EITF 08-7"), requires an acquiring entity to account for defensive intangible assets as a separate unit of accounting. Defensive intangible assets should not be included as part of the cost of the acquirer's existing intangible assets because the defensive intangible assets are separately identifiable. Defensive intangible assets must be recognized at fair value in accordance with SFAS 141(R) and SFAS 157. EITF 08-7 will be effective for the reporting period beginning after December 15, 2008. The impact of EITF 08-7 on the Company's consolidated financial statements will depend on

the nature and size of acquisitions, if any, subsequent to the effective date

In May 2008, the FASB issued SFAS No. 162, "The Hierarchy of Generally Accepted Accounting Principles". SFAS 162 identifies the sources of accounting principles and the framework for selecting the principles to be used in the preparation of financial statements of nongovernmental entities that are presented in conformity with generally accepted accounting principles in the United States. It is effective 60 days following the SEC's approval of the Public Company Accounting Oversight Board amendments to AU Section 411, "The Meaning of Present Fairly in Conformity With Generally Accepted Accounting Principles". The Company does not expect SFAS No. 162 to have a material effect on its financial statements.

In October 29, 2008, the FASB issued FSP No.132 (R)-a, "Employers' Disclosures about Pensions and Other Postretirement Benefits," to require that an employer disclose the following information about the fair value of plan assets: 1) the level within the fair value hierarchy in which fair value measurements of plan assets fall; 2) information about the inputs and valuation techniques used to measure the fair value of plan assets; and 3) a reconciliation of beginning and ending balances for fair value measurements of plan assets using significant unobservable inputs. The FSP will be effective for fiscal years ending after December 15, 2009, with early application permitted. Application of the FSP would not be required for earlier periods that are presented for comparative purposes. The Company is currently evaluating the potential impact of adopting this FSP on the disclosures in its financial statements.

NOTE 2: SIGNIFICANT ACCOUNTING POLICIES (Cont.)

In June 2008, the FASB issued FSP EITF No. 03-6-1 "Determining Whether Instruments Granted in Stock-based Payment Transactions Are Participating Securities". Under the FSP, unvested stock-based payment awards that contain rights to receive non-forfeitable dividends (whether paid or unpaid) are participating securities, and should be included in the two-class method of computing EPS. The FSP is effective for fiscal years beginning after December 15, 2008, and interim periods within those years. The Company is currently evaluating the impact of EITF 03-6-1 on its financial statements.

aa. Reclassification:

Certain 2007 figures have been reclassified to conform to the 2008 presentation. The reclassification had no effect on previously reported net income (loss), shareholders' equity or cash flows.

NOTE 3: MARKETABLE SECURITIES

The Company invests in marketable debt securities, which are classified as held-to-maturity investments and included as part of short-term bank deposits and held-to-maturity marketable securities balance. The following is a summary of the Company's marketable debt securities:

	December 31,					
	2008			2007		
	Amortized cost*)	Unrealized gain (loss) *)	Market value	Amortized cost*)	Unrealized gain (loss) *)	Market value
Held-to-maturity:						

	December 31,					
Israeli Government debentures	$ 4,517	$ 6	$ 4,523	$ 4,260	(3)	$ 4,257
U.S. Government debentures	58,757	38	58,795	41,134	195	41,329
	$ 63,274	$ 44	$ 63,318	45,394	192	45,586

*) Israeli and U.S Government debentures include accrued interest to be received, disclosed as part of other current assets , in the amount of approximately $ 2 and $ 239 respectively as of December 31, 2008 and $ 64 and $ 1,302 respectively, as of December 31, 2007. There are no unrealized losses with respect to these debentures as of December 31, 2008.

NOTE 4: INVENTORIES

a. Inventories are comprised of the following:

	December 31,	
	2008	2007
Raw materials, parts and supplies	$ 1,348	$ 8,657
Work in progress	950	4,250
Finished products	18,421	11,887
	$ 20,719	$ 24,794

b. Inventory write-offs totaled $ 1,556, $ 500 and $ 1,210 in 2008, 2007 and 2006, respectively.

NOTE 5: PROPERTY AND EQUIPMENT, NET

a. Composition of property and equipment, grouped by major classifications, is as follows:

	December 31,	
	2008	2007
Cost:		
Buildings and land	$ 92,490	$ 92,114
Computers and electronic equipment	89,039	82,307
Equipment leased to others	106,031	98,837
Office furniture and equipment	9,109	8,968

	December 31,	
Vehicles	427	375
Leasehold improvements	6,053	5,806
	303,149	288,407
Accumulated depreciation and provision for impairment *)	193,780	183,160
Depreciated cost	$ 109,369	$ 105,247

*) The accumulated depreciation of equipment leased to others as of December 31, 2008 and 2007 is $ 89,944 and $ 85,518, respectively.

b. Depreciation expenses totaled $ 12,502, $ 16,848 and $ 19,769 in 2008, 2007 and 2006, respectively.

c. In 2008 and 2007, the Group recorded impairment losses in respect of its long lived assets in Colombia, see also Note 11.

d. As for pledges and securities, see also Note 13f.

NOTE 6: INTANGIBLE ASSETS AND DEFERRED CHARGES, NET

a. Composition of intangible assets and deferred charges, grouped by major classifications, is as follows:

	Weighted average amortization	December 31,	
		2008	2007
	years		
Cost:			
Identifiable intangible assets resulting from acquisitions of a subsidiary	12.6	$ 21,159	$ 22,599
Customer acquisition costs		-	1,416
Other	5	1,483	1,293
		22,642	25,308
Accumulated amortization		19,221	21,448
Amortized cost		3,421	3,860

	Weighted average amortization	December 31,	
Deferred charges		643	911
		$ 4,064	$ 4,771

b. Amortization expenses amounted to $ 630, $ 867 and $ 959 for the years ended December 31, 2008, 2007 and 2006, respectively.

c. Estimated amortization expenses for the following years is as follows:

Year ending December 31,	
2009	$ 639
2010	639
2011	639
2012	639
2013 and thereafter	865
	$ 3,421

NOTE 7: COMMITMENTS AND CONTINGENCIES

a. On March 29, 2001, Spacenet completed a transaction for the sale and leaseback of its corporate headquarters building. The sale price of the property was approximately $ 31,500 net of certain fees and commissions. Concurrently with the sale, Spacenet entered into an operating leaseback contract for a period of fifteen years at an initial annual rent of approximately $ 3,500 plus escalation. The capital gain resulting from the sale and leaseback amounting to $ 5,600 was deferred and is being amortized over the fifteen year term of the lease. In accordance with the lease terms, Spacenet made a security deposit consisting of a $ 5,800 fully cash collateralized letter of credit for the benefit of the lessor. The lease is accounted for as an operating lease in accordance with Statement of Financial Accounting Standards No. 13, Accounting for Leases (SFAS No. 13).

b. Lease commitments:

Minimum lease commitments of certain subsidiaries under non-cancelable operating lease agreements with respect to premises occupied by them, at rates in effect subsequent to December 31, 2008, are as follows:

NOTE 7: COMMITMENTS AND CONTINGENCIES (Cont.)

Year ending December 31,	Gross commitments	Receivables from subleases	Net commitments
2009	$ 5,605	$ 1,348	$ 4,257

Year ending December 31,	Gross commitments	Receivables from subleases	Net commitments
2010	5,087	1,287	3,800
2011	5,110	1,069	4,041
2012	5,110	967	4,143
2013	5,206	647	4,559
2014 and therafter	11,849	-	11,849
	$ 37,967	$ 5,318	$ 32,649

Gross rent expenses and income from subleases were $ 7,016 and $ 1,508, respectively in 2008, $ 6,493 and $ 1,169, respectively in 2007, $ 6,642 and $ 1,416, respectively in 2006,

Out of the above commitment, $ 2,152 is included as restructuring accrual in other accounts payable and other long-term liabilities as of December 31, 2008. Some of the Group s lease agreements do not include renewal options.

c. Commitments with respect to space segment services:

Future minimum payments due for space segment services subsequent to December 31, 2008, are as follows:

Year ending December 31,	
2009	$ 26,752
2010	14,507
2011	9,755
2012	4,050
2013 and thereafter	586
	$ 55,650

Space segment services expenses totaled $ 26,628, $ 23,970 and $ 23,698 in 2008, 2007 and 2006, respectively.

d. In 2008 and 2007, the Company s primary material purchase commitments derived from inventory s suppliers. The Company s material inventory purchase commitments are based on purchase orders, or on outstanding agreements with some of the Company s suppliers of inventory. As of December 31, 2008 and 2007, the Company major outstanding inventory purchase commitments amounted to $ 18,963 and $ 18,400, respectively, all of which were orders placed or commitments made in the ordinary course of its business. As of December 31, 2008 and 2007, $ 10,482 and $ 13,000, respectively, of these orders and commitments, were from suppliers which can be considered sole or limited in number.

NOTE 7: COMMITMENTS AND CONTINGENCIES (Cont.)

e. Legal and tax contingencies:

1. In September 2003, Nova Mobilcom S.A., or Mobilcom, filed a lawsuit against Gilat do Brail for specific performance of a Memorandum of Understanding which provided for the sale of Gilat do Brasil, and specifically the GESAC project, a government education project awarded to Gilat do Brazil, to Mobilcom for an unspecified amount. Gilat do Brasil does not believe that this claim has any merit and is vigorously defending itself against the claims presented therein.

2. In 2003, the Brazilian tax authority has filed a claim against a subsidiary of Spacenet in Brazil, for alleged taxes due of approximately $4,000. In January 2004, the subsidiary received notice of an administrative ruling reducing the amount of the claim, and the subsidiary filed an appeal of such ruling. In December 2005, this appeal was denied and as of December 31, 2008, the subsidiary faces a tax liability of approximately $ 6,700 (the amount has increased due to interest and exchange rate differences). The subsidiary denies such claims and has filed a petition known as a Ação Anulatória in the State Courts of the State of São Paulo, Brazil.

3. On March 31, 2008 the Company announced the signing of a Merger Agreement to be acquired for an aggregate value of $ 475,000 in an all cash transaction by a consortium of private equity investors. On August 5, 2008 the Company informed the consortium that all conditions precedent to closing has been met. On August 29, 2008 the Company notified the consortium that it was terminating the Merger Agreement citing the consortium members intentional breach of the Merger Agreement and failure to close the merger transaction within the extended time period established to complete the transaction. In November 2008, the Company filed lawsuits against each of the parties that had guaranteed the payment of a termination fee under the Merger Agreement. The lawsuits were filed in the Tel Aviv District Court against Mivtach Shamir Holdings Ltd., LR Group Ltd., Gores Capital Partners II, L.P, and DGB Investments, Inc. for their pro rata commitment to guarantee the termination fee due to the Company. The Merger Agreement provides for a termination fee in the amount of $47,500, payable to the Company, in the event of an intentional breach of the agreement by the consortium. See also (4) below.

4. In October 2008 a lawsuit and a motion for its approval as a class action proceeding was filed in the District Court of Jerusalem by eight individuals and Israeli companies against the Company, all of its directors and its 20% shareholder, York Capital Management. The plaintiffs claim damages based on the amounts they would have been paid had the merger with the consortium closed. The Company and its independent legal counsel believe the claims are completely without merit, and that the lawsuit is without basis. The Company intends to use all legal means necessary to protect and defend the Company and its directors.

5. The Company has certain tax exposures in some of the jurisdictions in which it conducts business. Specifically, in certain jurisdictions in the United States and in Latin America the Company is in the midst of different stages of audits and has received certain tax assessments. The tax authorities in these and in other jurisdictions in which the Company operates as well as the Israeli Tax Authorities may raise additional claims, which might result in increased exposures and ultimately, payment of additional taxes.

NOTE 7: COMMITMENTS AND CONTINGENCIES (Cont.)

6. The Company has accrued, $ 15,291 and $ 15,076 as of December 31, 2008 and 2007, respectively, for the expected implications of such legal and tax contingencies. These accruals are comprised of $ 14,295 and $ 13,779 of tax related accruals as of December 31, 2008 and 2007, respectively, and $ 996 and $ 1,297 of legal and other accruals as of December 31, 2008 and 2007, respectively. The accruals related to tax contingencies have been assessed by the Company s management based on the advice of outside legal and tax advisers. The total estimated exposure for the aforementioned tax related accruals is $ 23,284 and $ 24,519 as of December 31, 2008 and 2007, respectively. The estimated exposure for legal and other related accruals is $ 1,599 and $ 1,438 as of December 31, 2008 and 2007, respectively.

The tax accruals include various tax matters such as taxes on income, property taxes, sales and use tax and value added tax, that are in different stages of audits, for which tax assessments have been received, or various tax exposures in which the Company has assessed the exposure and determined that an accrual is necessary. The accruals related to legal contingencies have been assessed by the Company s management based on the advice of independent legal advisers and are comprised of matters for which legal proceedings have been initiated against the Company.

The exposures and provisions related to income taxes have been assessed and provided for in accordance with FIN 48. Liabilities related to legal proceedings, demands and claims and other taxes are recorded in accordance with SFAS 5, when it is probable that a liability has been incurred and the associated amount can be reasonably estimated. The Company s management, based on its legal counsel opinion, believes that it had provided an adequate accrual to cover the costs to resolve the aforementioned legal proceedings, demands and claims.

f. Pledges and securities see Note 10a and 13f.

g. Guarantees:

The Group guarantees its performance to certain customers (generally to government entities) through bank guarantees and corporate guarantees. Guarantees are often required for the Group s performance during the installation and operational periods of long-term rural telephony projects such as in Latin America, and for the performance of other projects (government and corporate) throughout the rest of the world. The guarantees typically expire when certain operational milestones are met.

As of December 31, 2008, the aggregate amount of bank guarantees outstanding in order to secure the Group s various performance obligations was approximately $14,700, including an aggregate of approximately $6,300 on behalf of the subsidiary in Peru. The Group has restricted cash as collateral for these guarantees in an amount of approximately $1,900.

In order to guarantee the Company s performance obligations for its Colombian activities, the Company secured insurance from a local insurance company in Colombia. The Company has provided the insurance company with various corporate guarantees, guaranteeing the Company s performance and its employee salary and benefit costs for in excess of $27,000 and $5,000 respectively.

NOTE 7: COMMITMENTS AND CONTINGENCIES (Cont.)

In addition, the Group has provided bank guarantees for certain leases throughout the world for an aggregate amount of approximately $ 5,846. The Group has restricted cash as collateral for these guarantees in an amount of approximately $ 5,846. The Group also provided other guarantees of approximately $ 1,903 as of December 31, 2008.

In accordance with FIN 45, paragraph 4, as the guarantees above are performance guarantees for the Company s own performance, such guarantees are excluded from the scope of FIN 45. The Company has not recorded any liability for such amounts, since the Company expects that its performance will be acceptable. To date, no guarantees have ever been exercised against the Company.

NOTE 8: HEDGING INSTRUMENTS

To protect against changes in value of forecasted foreign currency cash flows resulting from salaries and other payments that are denominated in NIS, the Company has entered into foreign currency forward contracts and put option contracts. These contracts are designated as cash flows hedges, as defined by SFAS No. 133, as amended, and are considered highly effective as hedges of these expenses.

During the year ended December 31, 2008 and 2007, the Company recognized a net income of $ 667 and $ 792, respectively, related to the effective portion of its hedging instruments. The effective portion of the hedged instruments has been included as an offset of payroll expenses and other operating expenses in the statement of operations. The ineffective portion of the hedged instrument amounted to $ 186 and $ 138 during the years ended December 31, 2008 and 2007, respectively and has been recorded as a financial income.

The fair value of the hedging instruments as of December 31, 2008 constituted an asset of approximately $ 1,096. As of December 31, 2007 the Company had no outstanding hedging instruments. The term of all of these instruments as of December 31, 2008 are less than one year.

At December 31, 2008, the Company expects to reclassify $ 1,096 of net gain on derivative instruments from accumulated other comprehensive income to earnings during the next twelve months.

NOTE 9: SHAREHOLDERS EQUITY

a. Share capital:

1. Ordinary shares confer upon their holders voting rights, the right to receive cash dividends and the right to share in excess assets upon liquidation of the Company.

2. In September 2006, the Company issued 10,578,474 ordinary shares to York upon the conversion of its long-term convertible note. See also Note 1d and 10e.

NOTE 9: SHAREHOLDERS EQUITY (Cont.)

3. In December, 2006, the Company consummated a public offering of 8,050,000 ordinary shares at a price of $8.50 per share. Of such shares, 5,016,667 ordinary shares were issued by the Company and the remaining shares were sold by a selling shareholder (York). Through this offering the Company raised gross proceeds of $ 42,641. Issuance expenses amounted to approximately $ 2,755.

4. During the years ended December 31, 2008, 2007 and 2006, 436,718, 790,563 and 668,913 options, were exercised for ordinary shares and the same number of the ordinary shares were issued, respectively.

b. Stock Option Plans:

The Company adopted SFAS 123(R) using the modified prospective transition method, which requires the application of the accounting standard starting from January 1, 2006, the first day of the Company s fiscal year 2006. Under that transition method, compensation cost recognized in the years ended December 31, 2008, 2007 and 2006, includes: (a) compensation cost for all stock-based payments granted prior to, but not yet vested as of January 1, 2006, based on the grant date fair value estimated in accordance with the original provisions of Statement 123, and (b) compensation cost for all stock-based payments granted subsequent to January 1, 2006, based on the grant-date fair value estimated in accordance with the provisions of Statement 123(R). Results for prior periods have not been restated.

The Company recognizes compensation expenses for the value of its awards, which have graded vesting, granted prior to January 1, 2006, based on the accelerated attribution method and for awards granted subsequent to January 1, 2006, based on the straight line method over the requisite service period of each of the awards.

Description of Plans

The Company has four stock option plans, the 1995 and the 2003 Stock Option and Incentive Plans and the 2005 and 2008 Stock Incentive Plans (the Plans). The 1995 Plan was amended in 1997, 1998 and 1999, and expired although there are still options outstanding under this plan. Under the 2003 Plan, options may be granted to employees, officers, directors and consultants of the Company.

In 2005, the Company s shareholders approved two increases in the number of options available for grant under the 2003 Plan from an aggregate of 4,635,000 shares to a total of 6,135,000 shares available for future grants. As of December 31, 2008, an aggregate of 698,763 shares of the Company are still available for future grants under the 2003 Plan.

The exercise price per share under the 1995 Plan was not less than the market price of an ordinary share at the date of grant. The exercise price per share under the 2003 Plan is the higher of (i) $ 5.00 per share; and (ii) the market value of the shares as of the date of the option grant, unless otherwise provided in the stock option agreement.

NOTE 9: SHAREHOLDERS EQUITY (Cont.)

In December 2005, the Company s shareholders approved the adoption of a new plan, the 2005 Plan with 1,500,000 shares or stock options available for grant. This Plan is designed to enable the Company s Board of Directors to determine various forms of incentives for all forms of service providers and, when necessary, adopt a sub-plan in order to grant specific incentives. Among the incentives that may be adopted are share options, performance share awards, performance share unit awards, restricted shares, restricted share unit awards and other stock-based awards. As of December 31, 2008, the Company granted 50,000 performance based options under the 2005 Plan, based on attaining sales target conditions, which are outstanding as of December 31, 2008 and 2007. As of December 31, 2008 the Company did not record any expenses relating to these options since achievement of the sales target is not expected. As of December 31, 2008, an aggregate of 10,000 shares of the Company are still available for future grants from the 2005 Plan.

In October 2008, the compensation/ stock option committee of the Company s board of directors approved the adoption of a new plan, the 2008 Plan with 1,000,000 shares or stock options available for grant and a sub-plan to enable qualified optionees certain tax benefits under the Israeli Income Tax Ordinance. Among the incentives that may be adopted are share options, performance share awards, performance share unit awards, restricted shares, restricted share unit awards and other stock-based awards. As of December 31, 2008, an aggregate of 365,000 shares of the Company are still available for future grants under the 2008 Plan.

Options granted under the plans above generally vest quarterly over two to four years. The options expire six, seven or ten years from the date of grant. Any options, which are forfeited or canceled before expiration, become available for future grants.

Valuation Assumptions

The Company estimates the fair value of stock options granted using the Black-Scholes-Merton option-pricing model. The option-pricing model requires a number of assumptions, of which the most significant are expected stock price volatility and the expected option term. Expected volatility was calculated based upon actual historical stock price movements.

The expected option term represents the period that the Company s stock options are expected to be outstanding and based on historical incidence of exercise of options. Prior to December 31, 2007, the expected term of options was determined based on the simplified method permitted by SAB No. 107 as the average of the vesting period and the contractual term. Starting January 1, 2008, the expected term of options granted is based upon historical experience complying with SAB 110. The risk-free interest rate is based on the yield from U.S. Treasury zero-coupon bonds with an equivalent term. The Company has historically not paid dividends and has no foreseeable plans to pay dividends.

GILAT SATELLITE NETWORKS LTD. AND ITS SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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

NOTE 9: SHAREHOLDERS EQUITY (Cont.)

Options granted to employees

The fair value of the Company s stock options granted to employees and directors for the years ended December 31, 2008, 2007 and 2006 was estimated using the following weighted average assumptions:

	Year ended December 31,		
	2008	2007	2006
Risk free interest	1.18%	4.5%	4.7%
Dividend yields	0%	0%	0%
Volatility	45%	45%	47%
Expected term (in years)	3.6	6.1	5.4

A summary of employee option activity under the Company s Stock Option Plans as of December 31, 2008 and changes during the year ended December 31, 2008 are as follows:

	Number of options	Weighted-average exercise price	Weighted-average remaining contractual term (in years)	Aggregate intrinsic value (in thousands)
Outstanding at December 31, 2007	4,097,030	$ 8.6	7.6	$ 17,298
Granted	630,000	$ 4.3		
Exercised	(336,718)	$ 6.0		
Expired	(3,846)	$ 895.5		
Forfeited	(92,842)	$ 13.7		
Outstanding at December 31, 2008	4,293,624	$ 7.2	6.5	-
Exercisable at December 31, 2008	3,541,578	$ 7.7	6.7	-
Vested and expected to vest at December 31, 2008	4,215,082	$ 7.2	6.6	-

A summary of employee option activity under the Company s Stock Option Plans as of December 31, 2007 and 2006 and changes during the years ended on those dates are as follows:

	Year ended December 31,			
	2007		2006	
	Number of options	Weighted average exercise	Number of options	Weighted average exercise

	Year ended December 31,	price		price
Options outstanding at the beginning of the year	4,840,322	$ 8.8	5,159,835	$ 8.6
Changes during the year:				
Granted	90,500	$ 8.7	312,000	$ 7.2
Exercised	(781,075)	$ 5.8	(521,851)	$ 5.6
Expired	(3,373)	$ 465.0	(499)	$ 346.3
Forfeited	(49,344)	$ 39.7	(109,163)	$ 10.9
Options outstanding at the end of the year (*)	4,097,030	$ 8.6	4,840,322	$ 8.8
Options exercisable at the end of the year	3,346,423	$ 9.0	3,514,823	$ 9.8

NOTE 9: SHAREHOLDERS EQUITY (Cont.)

The weighted-average grant-date fair value of options granted during the years ended December 31, 2008, 2007 and 2006 was $ 0.55 ,$ 4.3 and $ 3.55, respectively. The aggregate intrinsic value in the table above represents the total intrinsic value (the difference between the Company s closing stock price on the last trading day of the year 2008 and the exercise price, multiplied by the number of in-the-money options) that would have been received by the option holders had all option holders exercised their options on December 31, 2008. This amount changes, based on the fair market value of the Company s stock. Total intrinsic value of options exercised for the years ended December 31, 2008, 2007 and 2006 was approximately $ 2,127, $ 3,190 and $ 1,574, respectively.

Total grant-date fair value of options that vested during the years ended December 31, 2008, 2007 and 2006 was approximately $ 14,429, $ 15,564 and $17, 645, respectively.

The options outstanding under the Company s Stock Option Plans as of December 31, 2008, have been separated into ranges of exercise price as follows:

Ranges of exercise price	Options outstanding as of December 31, 2008	Weighted average remaining contractual life (years)	Weighted average exercise price	Options exercisable as of December 31, 2008	Weighted average exercise price of exercisable options
$ 4.0 - 6.0	3,597,758	6.7	$ 5.4	3,006,091	$ 5.7
$ 6.0 - 8.9	595,399	6.1	$ 7.3	466,584	$ 7.0
$ 9.2 - 10.8	41,175	6.0	$ 10.1	9,611	$ 10.1
$ 42.4 - 79.0	55,572	3.0	$ 77.5	55,572	$ 77.5
$ 240.4 - 2,730.0	3,720	1.6	$ 682.5	3,720	$ 682.5

Ranges of exercise price	Options outstanding as of December 31, 2008	Weighted average remaining contractual life (years)	Weighted average exercise price	Options exercisable as of December 31, 2008	Weighted average exercise price of exercisable options
	4,293,624	6.5	$ 7.2	3,541,578	$ 7.7

Restricted Share Units (RSUs) granted to employees and non-employees

The fair value of RSUs is estimated based on the market value of the Company s stock on the date of the award.

In November 2008, the Company granted 1,455,000 RSUs. The entitlement to these RSUs vest over a four-year period (20%, 20%, 30%, 30% each year, respectively) in quarterly batches, The following table summarizes information regarding the number of RSUs issued and outstanding as of December 31, 2008:

Employees:

	Year ended December 31, 2008	
	Number of RSUs	Weighted average grant date fair value
RSUs outstanding at the beginning of the year	-	-
Changes during the year:		
Granted	1,455,000	$ 2.7
Vested	-	-
Forfeited	-	-
RSUs outstanding at the end of the year	1,455,000	$ 2.7

NOTE 9: SHAREHOLDERS EQUITY (Cont.)

Non-employees:

	Year ended December 31, 2008

	Year ended December 31, 2008	
	Number of RSUs	Weighted average grant date fair value
RSUs outstanding at the beginning of the year	-	-
Changes during the year:		
Granted	20,000	$ 2.7
Vested	-	-
Forfeited	-	-
RSUs outstanding at the end of the year	20,000	$ 2.7

Additional stock-based compensation data

As of December 31, 2008, there was approximately $ 4,691 of total unrecognized compensation costs related to non-vested stock-based compensation arrangements granted under the Plans. That cost is expected to be recognized over a weighted-average period of 2.12 years.

c. In December 2008, the Company granted 600,000 stock options to its Chairman of the Board of Directors and CEO and the other members of the board of directors at an exercise price of $4.00 per share. These options vest ratably, each quarter, over a three-year period. The fair value of these options was estimated at $ 234, using a Black-Scholes option-pricing valuation model which is expected to be recognized over a weighted-average period of 3.58 years. These grants are detailed in the above table.

d. Dividends:

1. In the event that cash dividends are declared by the Company, such dividends will be declared and paid in Israeli currency. Under current Israeli regulations, any cash dividend in Israeli currency paid in respect of ordinary shares purchased by non-residents of Israel with non-Israeli currency, may be freely repatriated in such non-Israeli currency, at the exchange rate prevailing at the time of repatriation. The Company does not expect to pay cash dividends in the foreseeable future.

2. Pursuant to the terms of a credit line from a bank (see also Note 13), the Company is restricted from paying cash dividends to its shareholders without initial approval from the bank.

NOTE 10: RESTRUCTURING OF DEBTS

a. In 2003, the Company issued the 4.00% Convertible Subordinated Note due 2012. The Company pays interest on its 4.00% Convertible Subordinated Note semi-annually in arrears on April 1 and October 1 of each year, beginning on April 1, 2005. The Company is committed to pay $ 426 of the principal amount of the notes on each of April 1 and October 1, in both 2010 and 2011, and the remaining principal amount at maturity. The notes are convertible at the option of the holder into the Company s Ordinary shares at a conversion price of $ 17.4 per Ordinary share at any time before close of business on October 1, 2012, unless the notes have been converted pursuant to a mandatory conversion clause as defined in the 4.00% Convertible Subordinated Note.

Commencing January 1, 2005, the Company may, at its option, require the conversion right to be exercised under certain circumstances set forth in the indenture. The collateral for the notes is a second priority security interest consisting of a floating charge on all of the Company s assets and a pledge of all on the shares of Spacenet, a wholly owned subsidiary of the Company.

The interest of the holders of the notes in the collateral is subordinated to the security interest granted for the benefit of lending banks. As of December 31, 2008 and 2007, the outstanding amount of the notes is $ 16,315.

The balance of the notes results from debt restructurings that occurred in 2003. The debt restructurings were accounted for as troubled debt restructuring on the basis of combination of types of restructuring and on the basis of modification of terms pursuant to Statement of the Financial Accounting Standard No. 15 Accounting by Debtors and Creditors for Troubled Debt Restructurings (SFAS 15), Emerging Issues Task Force No. 02-4 Determining Whether a Debtor s Modification or Exchange of Debt Instruments Is within the Scope of FASB Statement No. 15 (EITF 02-4) and SFAS No. 145, Rescission of SFAS No. 4, 44 and 64, Amendment of SFAS No. 13, and Technical Corrections . Accordingly, the Company recognized a gain in 2003. As part of the accounting for the troubled debt restructurings, the Company accrued to the balance of the notes the remaining future interest payable until maturity, presented as a separate line item in the balance sheet. Therefore, at each reporting date the liabilities include both principal and all future remaining interest payments. Consequently, though the Company pays periodical interest payments, the statement of operations does not reflect the costs of such interest payments.

b. In April 2004, the Company further revised the terms of its loan from Bank Hapoalim, to which it owed a principal debt amount of $ 71,400. The new loan terms reduced the principal installments due on July 1, 2005 and January 1, 2006 from $ 4,463 to $ 1,000 and $ 1,500, respectively, with the remainder due for payment in 2012. Other principal payments of $ 4,463 due semi-annually thereafter remained unchanged and the last installment of $ 15,300 is due on July 2, 2012. In addition, the interest rate on the loan was also revised.

In consideration for the Bank Hapoalim agreement to amend the interest rates, defer principal payments and modify certain covenants, the bank was entitled to convert the loan owed by the Company to Bank Hapoalim into Ordinary shares of the Company.

The modification of the loan terms was accounted for as debt extinguishment due to the addition of a conversion option to the debt instrument which was considered substantial. The fair value of the amended loan was recorded, and the book value of the old loan was removed from the Company s financial statements. Since Bank Hapoalim was a related party, the extinguishment gain of approximately $ 15,500 was recorded as an equity contribution in the year ended December 31, 2004.

NOTE 10: RESTRUCTURING OF DEBTS (Cont.)

c. In July 2005, Bank Hapoalim assigned its loan to the Company to York. Following the assignment, York is considered a related party. At that time of the assignment, certain board members of the Company resigned and were replaced by new board members. In addition, the Company s CEO and Chairman of the Board of Directors resigned and a co-founder of the Company rejoined the Company as President and Chief Executive Officer.

d. In December 2005, the Company and York further revised the terms of the loan. The new loan terms deferred $ 19,350 in principal payments due in installments from January 5, 2006 through January 1, 2008. The new payment schedule provided that: (i) no principal payments be due in 2006, 2007 or January 2008 (with those payments being deferred until July 2012) (ii) approximately $ 4,500 was to be paid on July 1, 2008; (iii) approximately $ 9,000 was to be paid in semi-annual installments on January 1 and July 1 of 2009, 2010 and 2011; (iv) approximately $ 4,500 was to be paid on January 1, 2012; and (v) approximately $ 34,500 was to be paid on July 1, 2012. In addition, the amendment modified the terms of the conversion option until September 30, 2006. The amendment lowered and set the conversion price to $ 6.75 per share until September 30, 2006. In addition, during this period, the Company was granted the right to require the conversion of the outstanding loan from York at the same exercise price in the event that the closing share price of the Company s Ordinary shares as published by NASDAQ over

twenty consecutive trading days will exceed $ 9, provided that the aggregate trading volume during this period is a minimum of 1,700,000 Ordinary shares. Beginning October 1, 2006, the conversion price reverts to the original price.

The modification of the loan was not considered substantial based on the measurement method prescribed by EITF 96-19, Debtor s Accounting for a Modification or Exchange of Debt Instruments . In accordance with EITF 05-7, Accounting for Modifications to Conversion Options Embedded in Debt Instruments and Related Issues which was early adopted by the Company, the change in the fair value of the conversation option immediately before and after the modification in the amount of $ 3,800 was recorded as a discount on the loan and increase to shareholders equity.

e. In September 2006, York converted the loan into the Company s Ordinary shares. Based on Interpretation 1 of Opinion 26 and EITF No. 85-17, Accrued Interest upon Conversion of Convertible Debt , the net carrying amount of the convertible debt and accrued interest unpaid, including the unamortized discount, in the total amount of $ 68,100 was credited to shareholders equity upon conversion. See also Note 1d.

NOTE 11: IMPAIRMENT OF LONG-LIVED ASSETS AND OTHER CHARGES

Most of the activity of SRC in Colombia consists of operating subsidized projects for the government (the Compartel Projects) were awarded to Gilat s Colombian subsidiaries in 1999 and 2002. In accordance with these projects, the Colombian government has transferred approximately $70,000 to trust accounts. The amount is released from the trusts based on a schedule of payments and meeting certain operational milestones. As of December 31, 2008 and 2007, short-term and long-term restricted cash held by trustees accounts amounted to approximately $24,000 not yet being released from the trusts as certain operational milestones imposed had not been fully met. The Colombian government and the Company agreed to renegotiate certain terms of the contracts, including the operational milestones going forward, so that they better reflect the current telecom and business environment in Colombia. Such amended agreements were signed on December 30, 2008.

In accordance with the guidelines of Statements of Financial Accounting Standards No. 144, Accounting for the impairment or disposal of long lived assets (SFAS 144), in 2007, the Company compared the carrying amount of its long lived network assets group to the future undiscounted cash flows expected to be generated by those assets. Since the undiscounted cash flow expected to be generated by those assets were less than the long lived networks assets group carrying amount, the Company determined the fair value of its long lived networks assets group and concluded that the carrying amount of its long lived network assets group in Colombia exceeded their fair value and recorded an impairment of long lived assets and other charges in an amount of $12,218.

As mentioned above, in December 2008 the Company signed amendments to the agreements for the provision of services under the Compartel Projects. The Company performed a cash flow analysis based on the guidance provided in SFAS 144, for these projects based on the revised terms. Based on such analysis, the Company recorded a loss representing an impairment of long lived assets and other charges in an amount of $ 5,020.

As to the Company s performance guarantees, see Note 7(g).

The Company ensured that the accumulated revenue recognized from the Compartel Projects will not exceed the accumulated amounts previously released from the trust.

The Company recorded losses of $ 5,020 and $ 12,218, as of December 31, 2008 and 2007, respectively, as follows:

	Year ended December 31, 2008	Year ended December 31, 2007

		Year ended December 31, 2008		Year ended December 31, 2007				
	66,229							
Income from continuing operations		200,504		212,807		187,590		173,674
Net income	$	200,504	$	212,807	$	187,590	$	173,674
Basic EPS:								
Income from continuing operations	$	1.46	$	1.55	$	1.40	$	1.30
Net income	$	1.46	$	1.55	$	1.40	$	1.30
Diluted EPS:								
Income from continuing operations	$	1.43	$	1.52	$	1.37	$	1.27
Net income	$	1.43	$	1.52	$	1.37	$	1.27
Consolidated Balance Sheet Data:								
Deferred acquisition costs	$	371,932	$	417,454	$	383,006	$	428,613
Prepaid reinsurance premiums		462,390		427,028		451,113		418,184
Reinsurance recoverable on unpaid losses		33,202		34,091		42,869		41,671
Derivative assets		270,648		270,485		252,637		252,544
Other assets		282,295		281,406		253,843		255,041
Total assets		33,756,665		33,766,662		34,784,595		34,797,180
Loss and loss adjustment expense reserves		755,563		778,064		667,570		690,801
Investment agreements		9,316,470		9,318,116		10,005,780		9,998,534
Deferred income taxes, net		573,849		563,551		661,184		654,888
Derivative liabilities		428,360		427,334		484,842		484,003
Other liabilities		381,426		397,724		396,596		412,019
Total liabilities		27,320,654		27,349,775		28,197,097		28,221,370
Retained earnings		5,377,327		5,361,923		5,527,063		5,497,743
Accumulated other comprehensive income		500,516		496,796		630,628		648,260
Total shareholders equity	$	6,436,011	$	6,416,887	$	6,587,498	$	6,575,810

Table of Contents

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

MBIA Inc. and Subsidiaries

The restatement of the Company s financial statements did not have a material effect on its financial condition and MBIA does not expect the restatement to have any impact on its ratings or on the Triple-A ratings of MBIA Insurance Corporation. Information presented in the Notes to Consolidated Financial Statements gives effect to the restatement, as applicable.

NOTE 3: SIGNIFICANT ACCOUNTING POLICIES

The consolidated financial statements have been prepared on the basis of accounting principles generally accepted in the United States of America (GAAP). The preparation of financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosures of contingent assets and liabilities at the date of the financial statements, and the reported amounts of revenues and expenses during the reporting period. As additional information becomes available or actual amounts become determinable, the recorded estimates are revised and reflected in operating results. Actual results could differ from those estimates. The Company s significant accounting policies are as follows:

CONSOLIDATION The consolidated financial statements include the accounts of the Company, its subsidiaries and entities under its control for which the Company retains substantially all the risks and rewards. This includes variable interest entities (VIEs) consolidated under the requirements of Financial Accounting Standards Board (FASB) Interpretation No. (FIN) 46(R), Consolidation of Variable Interest Entities. All significant intercompany balances have been eliminated. Certain amounts have been reclassified in prior years financial statements to conform to the current presentation. In addition, the Company has revised its 2004 and 2003 Consolidated Statements of Cash Flows to separately disclose the operating and investing portions of the cash flows attributable to discontinued operations. These amounts were previously reported on a combined basis.

INVESTMENTS The Company classifies its fixed-maturity investments as either available-for-sale or held-to-maturity, as defined by SFAS 115, Accounting for Certain Investments in Debt and Equity Securities. Available-for-sale investments are reported in the financial statements at fair value, with unrealized gains and losses, net of deferred taxes, reflected in accumulated other comprehensive income in shareholders equity. Bond discounts and premiums are amortized using the effective yield method over the remaining term of the securities. For pre-refunded bonds, the remaining term is determined based on the contractual refunding date. Investment income is recorded as earned. Realized gains or losses on the sale of investments are determined by specific identification and are included as a separate component of revenues.

Held-to-maturity investments consist mainly of debt securities, loans, lease receivables, trade receivables and floating rate notes. These investments are reported in the financial statements at amortized cost. Discounts and premiums are amortized using the straight-line method over the remaining term of the securities. Using an effective yield method to amortize discounts and premiums would not have produced materially different results. Investment income is recorded as earned.

Short-term investments are carried at amortized cost, which approximates fair value, and include all fixed-maturity securities with a remaining effective term to maturity of less than one year.

Other investments include the Company s interest in equity-oriented and equity method investments. The Company records its share of the unrealized gains and losses on equity-oriented investments, net of applicable deferred income taxes, in accumulated other comprehensive income in shareholders equity. The carrying amounts of equity method investments are initially recorded at cost and adjusted to recognize the Company s share of the profits or losses, net of any intercompany gains and losses, of the investees subsequent to the purchase date. Such profits and losses are recorded within net investment income in the accompanying Consolidated Statements of Income. Dividends are applied as a reduction of the carrying amount of equity method investments.

MBIA regularly monitors its investments in which fair value is less than amortized cost in order to assess whether such a decline in value is other than temporary and, therefore, should be reflected as a realized loss in net income. Such an assessment requires the Company to determine the cause of the decline and whether the Company possesses both the ability and intent to hold the investment to maturity or until the value recovers to an amount at least equal to amortized cost. This assessment requires management to exercise judgment as to whether an investment is impaired based on market conditions, trends and the availability of relevant data.

CASH AND CASH EQUIVALENTS Cash and cash equivalents include cash on hand and demand deposits with banks with original maturities of less than 90 days.

POLICY ACQUISITION COSTS Policy acquisition costs include those expenses that relate primarily to, and vary with, the acquisition of new insurance business. The Company periodically conducts a study to determine which operating costs have been incurred to acquire new insurance business and qualify for deferral. For business produced directly by MBIA Corp., such costs

Table of Contents

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

MBIA Inc. and Subsidiaries

include compensation of employees involved in underwriting and policy issuance functions, certain rating agency fees, state premium taxes and certain other underwriting expenses, reduced by ceding commission income on premiums ceded to reinsurers. Policy acquisition costs, net of ceding commissions, are deferred and amortized over the period in which the related premiums are earned.

MBIA will recognize a premium deficiency if the sum of expected loss and loss adjustment expenses and unamortized policy acquisition costs exceed the related unearned premiums. If MBIA were to have a premium deficiency that is greater than unamortized acquisition costs, the unamortized acquisition costs would be reduced by a charge to expense, and a liability (if necessary) would be established for any remaining deficiency. As of December 31, 2005, there have been no premium deficiencies. Although GAAP permits the inclusion of anticipated investment income when determining a premium deficiency, it is currently not being included in the Company s evaluation.

GOODWILL Goodwill represents the excess of the cost of acquiring a business enterprise over the fair value of the net assets acquired. Under SFAS 142, Goodwill and Other Intangible Assets, the Company tests the carry value of its goodwill for impairment at least annually. See Note 5 for an explanation of the Company s annual impairment test.

PROPERTY AND EQUIPMENT Property and equipment consists of land, buildings, leasehold improvements, furniture, fixtures and computer equipment and software. All property and equipment is recorded at cost and, except for land, is depreciated over the appropriate useful life of the asset using the straight-line method. Maintenance and repairs are charged to current earnings as incurred. The useful lives of each class of assets are as follows:

Buildings and site improvements	5-31 years
Leasehold improvements	4-10 years
Furniture and fixtures	8 years
Computer equipment and software	3-5 years

DERIVATIVES Under SFAS 133, all derivative instruments are recognized on the balance sheet at their fair value, and changes in fair value are recognized immediately in earnings unless the derivatives qualify as hedges. If the derivatives qualify as hedges, depending on the nature of the hedge, changes in the fair value of the derivatives are either offset against the change in fair value of assets, liabilities, or firm commitments through earnings, or are recognized in accumulated other comprehensive income until the hedged item is recognized in earnings. Any ineffective portion of a derivative s change in fair value is recognized immediately in earnings. If circumstances or events arise that require the termination and settlement of a derivative contract prior to maturity, any unrealized gain or loss will be recognized immediately in earnings. For qualifying fair value hedges, if the hedge relationship is terminated, the derivative fair value adjustment is reported as part of the basis of the hedged item and is amortized to earnings as a yield adjustment. For qualifying cash flow hedges, if the hedge relationship is terminated, the derivative fair value adjustment recorded in other comprehensive income is recognized in earnings at the time the hedged cash flows are recognized, consistent with the original hedge strategy. If the underlying hedged item of a hedge relationship ceases to exist, all changes in the fair value of the derivative are recognized in earnings each period until the derivative matures or terminates.

The nature of the Company s business activities require the management of various financial and market risks, including those related to changes in interest rates and foreign currency exchange rates. The Company uses derivative instruments to mitigate or eliminate certain of those risks. See Note 7 for a further discussion of the Company s use of derivatives and their impact on the Company s financial statements.

LOSSES AND LOSS ADJUSTMENT EXPENSES The financial guarantees issued by MBIA Corp. insure scheduled payments of principal and interest due on various types of financial obligations against a payment default on such payments by the issuers of the obligations. Loss and loss adjustment expense (LAE) reserves are established by the Company s Loss Reserve Committee, which is comprised of members of senior management, and require the use of judgment and estimates with respect to the occurrence, timing and amount of a loss on an insured obligation. As discussed below, the accounting for non-derivative financial guarantee loss reserves is possibly subject to change.

The Company establishes two types of loss and LAE reserves for non-derivative financial guarantees: an unallocated loss reserve and case basis reserves. The unallocated loss reserve is established on an undiscounted basis with respect to the Company s entire insured portfolio. The Company s unallocated loss reserve represents its estimate of losses that have or are probable to occur as a result of credit deterioration in the

Company s insured portfolio but which have not yet been specifically identified and applied to specific insured obligations. The unallocated loss reserve is increased on a quarterly basis using a formula that applies a loss factor to the Company s scheduled net earned premium for the respective quarter, both of which are defined and set forth below. This increase in the unallocated reserve is the Company s provision for loss and loss adjustment expenses as reported on the Company s income statement. Scheduled net earned premium represents quarterly premium earnings, net of reinsurance, from all policies in force less the portion of quarterly premium earnings that have been accelerated as a result of the refunding or defeasance of insured obligations. Total earned premium as reported on the Company s income statement includes both scheduled net earned premium and premium earnings that have been accelerated, net of reinsurance. Once a policy is originated, the amount of scheduled net earned

72

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

MBIA Inc. and Subsidiaries

premium recorded in earnings will be included in the Company s calculation of its unallocated loss reserve. When an insured obligation is refunded, defeased or matures, the Company does not reverse the unallocated loss reserve previously generated from the scheduled net earned premium on such obligation as the Company s unallocated loss reserve is not specific to any individual obligation.

Each quarter, the Company calculates its provision for the unallocated loss reserve as a fixed percent of scheduled net earned premium. This amount is recorded as Losses and loss adjustment expense on the income statement. Annually, the Loss Reserve Committee evaluates the appropriateness of the fixed percent loss factor. In performing this evaluation, the Loss Reserve Committee considers the composition of the Company s insured portfolio by municipal sector, structured asset class, remaining maturity and credit quality, along with the latest industry data, including historical default and recovery experience for the relevant sectors of the fixed-income market in order to determine if a trend is developing that indicates the loss factor should be increased or decreased. In addition, the Company considers its own historical loss activity and how those losses develop over time. The Loss Reserve Committee reviews the results of its annual evaluation over several years to determine whether any long-term trends are developing. The Company s additions to specific case basis reserves in the years ended December 31, 2005 and 2004 exceeded the 12% loss factor currently used by the Company. The Loss Reserve Committee is continuing to monitor this trend and evaluate whether an adjustment to the Company s current loss factor is appropriate. During the years ended December 31, 2005, 2004 and 2003, the Company calculated its provision for the unallocated loss reserve as 12% of scheduled net earned premium.

When a case basis reserve is established, MBIA reclassifies the estimated amount from its unallocated loss reserve in an amount equal to the specific case basis loss reserve. Therefore, the amount of available unallocated loss reserve at the end of each period is reduced by the actual case basis reserves established in the same period. Such reclassification has no effect on the Company s income statement as the unallocated loss reserve and specific case basis reserves, gross of recoveries from reinsurers, are reported as liabilities within Loss and loss adjustment expense reserves on the Company s balance sheet. In the event that case basis reserves develop at a significantly faster or slower rate than anticipated by applying the loss factor to net scheduled earned premium, the Company will perform a qualitative evaluation with respect to the adequacy of the remaining unallocated loss reserve. In performing this evaluation, the Company considers the anticipated amounts of future transfers to existing case basis reserves, as well as the likeliness those policies for which case basis reserves have not been established will require case basis reserves at a faster or slower rate than initially expected.

If, after establishing case basis reserves for the period, the Company determines that the remaining unallocated loss reserve is not sufficient to cover its estimate of losses not yet specifically identified in its insured portfolio, additional unallocated loss reserves will be accrued at such time which, as a result, will reduce the Company s earnings for the period. Conversely, if the Company determines that the remaining unallocated loss reserve is in excess of the amount needed to cover its estimate of unidentified losses, the Company will reverse the excess at such time which, as a result, will increase the Company s earnings for the period. The Company has not made any such adjustment to its unallocated loss reserve during the periods presented in these financial statements.

MBIA establishes new case basis reserves with respect to a specific insurance policy when the Loss Reserve Committee determines that (i) a claim has been made or is probable in the future with respect to such policy based on specific credit events that have occurred and (ii) the amount of the ultimate loss that MBIA will incur under such policy can be reasonably estimated. The amount of the case basis reserve with respect to any policy is based on the net present value of the expected ultimate losses and loss adjustment expense payments that the Company expects to pay with respect to such policy, net of expected recoveries under salvage and subrogation rights. The amount of the expected loss, net of expected recoveries, is discounted based on a discount rate equal to the actual yield of the fixed-income portfolio held by the Company s insurance subsidiaries at the end of the preceding fiscal quarter. The Company believes this yield is an appropriate rate of return for present valuing its reserves as it reflects the rate of return on the assets supporting future claim payments by the Company. The discount rate used at December 31, 2005, 2004 and 2003 was 5.0%, 4.8% and 4.7%, respectively. When a case basis reserve is established for an insured obligation, the Company continues to record premium revenue until it believes that premiums will no longer be collected on that obligation.

Case basis reserves are established in the same manner for policies with respect to which an insured event (i.e., a payment default on the insured obligation) has already occurred and for those policies where the Company expects that an insured event will occur in the future based upon credit deterioration which has already occurred and has been identified. This reserving methodology is different from case basis reserves that are established by traditional property and casualty insurance companies, which determine case basis reserves only upon the occurrence of an insured event when reported. The Company does not establish case basis reserves for all payments due under an insured obligation but rather only those that the Company believes the issuer of the insured obligation will be unable to make. Case basis reserves cover the amount of principal and interest owed that the Company expects to pay on its insured obligations and the costs of settlement and other loss mitigation

expenses, net of expected recoveries. Expected recoveries reduce the amount of case basis reserves established by the Company. When MBIA becomes entitled to the underlying collateral of an insured

Table of Contents

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

MBIA Inc. and Subsidiaries

credit under salvage and subrogation rights as a result of a claim payment, it records salvage and subrogation as an asset. Such amounts are included in the Company s balance sheet within Other assets.

A number of variables are taken into account in establishing specific case basis reserves for individual policies. These variables include the creditworthiness of the underlying issuer of the insured obligation, whether the obligation is secured or unsecured and the expected recovery rates on the insured obligation, the projected cash flow or market value of any assets that support the insured obligation and the historical and projected loss rates on such assets. Factors that may affect the actual ultimate realized losses for any policy include the state of the economy, changes in interest rates, rates of inflation and the salvage values of specific collateral. The methodology for determining when a case basis reserve is established may differ from other financial guarantee insurance companies, as well as from other property and casualty insurance enterprises.

Management believes that the Company s reserves are adequate to cover the ultimate net cost of claims. However, because the reserves are based on management s judgment and estimates, there can be no assurance that the ultimate liability will not exceed such estimates. See Note 23 for additional information regarding the Company s loss and LAE reserves.

The Company s loss reserving policy, described above, is based on guidance provided in SFAS 60, Accounting and Reporting by Insurance Enterprises, SFAS 5, Accounting for Contingencies and analogies to Emerging Issues Task Force (EITF) 85-20, Recognition of Fees for Guaranteeing a Loan. SFAS 60 requires that, for short-duration contracts, a liability for unpaid claim costs relating to insurance contracts, including estimates of costs relating to incurred but not reported claims, be accrued when insured events occur. Additionally, SFAS 5, requires that a loss be recognized where it is probable that one or more future events will occur confirming that a liability has been incurred at the date of the financial statements and the amount of loss can be reasonably estimated.

Although SFAS 60 provides guidance to insurance enterprises, the Company does not believe SFAS 60 comprehensively addresses the unique attributes of financial guarantee insurance contracts, as the standard was developed prior to the maturity of the financial guarantee industry. SFAS 60 provides guidance with respect to insurance contracts that are either short-duration or long-duration in nature. Financial guarantee contracts typically have attributes of both and, therefore, are difficult to classify as either. For instance, financial guarantee contracts are reported for regulatory purposes as property and liability insurance, normally considered short-duration, but have elements of long-duration contracts in that they are irrevocable and extend over a period that may be in excess of 30 years.

The Company believes its loss reserving policy reflects the requirements of applicable accounting literature, as well as the fact that financial guarantee losses occur over time as a result of credit deterioration, operational difficulties of the insured obligor or fraud, which may not be specifically detected when they occur but which can be generally estimated across a portfolio of insured obligations based on the credit quality and nature of the portfolio and historical default data. The Company does, however, recognize premium revenue and policy acquisition costs in a manner consistent with the guidance provided in SFAS 60 for short-duration contracts. If the Company and the rest of the financial guarantee industry were required to classify its insurance contracts as either short-duration or long-duration or if new specific guidance for financial guarantee insurance emerges, different methods of accounting could apply with respect to loss reserving and liability recognition, and possibly extend to premium revenue and policy acquisition cost recognition. Additionally, there are differences in the methodology and measurement of loss reserves followed by other financial guarantee companies.

As a result of discussions in January and February 2005 between the SEC staff and several financial guarantee industry participants, including MBIA, the FASB staff is considering whether additional guidance with respect to accounting for financial guarantee insurance should be provided. In June 2005, the FASB decided to add to its agenda a project to consider the accounting by insurers for financial guarantee insurance. As part of this project, the FASB is considering several aspects of the insurance accounting model for financial guarantee insurers, including claims liability recognition, premium recognition and the related amortization of deferred policy acquisition costs. When the FASB or the SEC reaches a conclusion on this issue, the Company and its financial guarantor peers may be required to change some aspects of their respective loss reserving policies and the potential changes could extend to premium and expense recognition. The Company cannot currently assess how the FASB and SEC staff s ultimate resolution of this issue will impact its loss reserving policy or the effect it might have on recognizing premium revenue and policy acquisition costs. Until the issue is resolved, the Company intends to continue to apply its existing policy with respect to the establishment of both case basis and unallocated loss reserves and the recognition of premium revenue and policy acquisition costs.

INVESTMENT AGREEMENTS, MEDIUM-TERM NOTES AND COMMERCIAL PAPER Investment agreements, medium-term notes and commercial paper are recorded on the balance sheet at the time such agreements are executed. The liabilities for investment agreements and medium-term notes are carried at their face value plus accrued interest. Interest expense is accrued at the contractual interest rate, adjusted for any premiums or discounts. Commercial paper is carried at face value adjusted for any discounts. Premiums and discounts related

74

Table of Contents

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

MBIA Inc. and Subsidiaries

to investment agreements and medium-term notes are amortized on a constant yield basis. Discounts related to commercial paper are amortized on a straight-line basis, which approximates a constant yield to maturity.

SECURITIES BORROWED OR PURCHASED UNDER AGREEMENTS TO RESELL AND SECURITIES LOANED OR SOLD UNDER AGREEMENTS TO REPURCHASE Securities borrowed or purchased under agreements to resell and securities loaned or sold under agreements to repurchase are accounted for as collateralized transactions and are recorded at contract value plus accrued interest, subject to the provisions of SFAS 140, Accounting for Transfers and Servicing of Financial Assets and Extinguishment of Liabilities. It is the Company s policy to take possession of securities borrowed or purchased under agreements to resell. Securities borrowed or loaned are primarily entered into to obtain securities that are repledged as part of MBIA s collateralized investment and repurchase agreement activity and are only transacted with high quality dealer firms.

PREMIUM REVENUE RECOGNITION Upfront premiums are earned in proportion to the expiration of the related insured par. Therefore, for transactions in which the premium is received upfront, premium earnings are greater in the earlier periods when there is a higher amount of par outstanding. The upfront premiums are apportioned to individual sinking fund payments of a bond issue according to an amortization schedule. After the premiums are allocated to each scheduled sinking fund payment, they are earned on a straight-line basis over the period of that sinking fund payment. Accordingly, deferred premium revenue represents the portion of premiums written that is applicable to the unexpired risk of insured bonds and notes. When an MBIA-insured issue is retired early, is called by the issuer, or is in substance paid in advance through a refunding accomplished by placing U.S. Government securities in escrow, the remaining deferred premium revenue is earned at that time since there is no longer risk to the Company. Installment premiums are earned on a straight-line basis over each installment period, generally one year or less.

Premiums ceded to reinsurers reduce the amount of earned premium the Company will recognize from its insurance policies. For both upfront and installment policies, ceded premium expense is recognized in earnings in proportion to and at the same time the related premium revenue is recognized. Ceding commission income is recognized in earnings at the time the related premium is recognized.

ADVISORY FEE REVENUE RECOGNITION The Company collects advisory fees in connection with certain transactions. Depending upon the type of fee received and whether it is related to an insurance policy, the fee is either earned when it is due or deferred and earned over the life of the related transaction. Work, waiver and consent, termination, administrative and management fees and expense reimbursements are earned when the related services are completed. Structuring fees are earned on a straight-line basis over the life of the related insurance policy and commitment fees are earned on a straight-line basis over the commitment period.

EMPLOYEE STOCK COMPENSATION The Company follows the fair value recognition provisions of SFAS 123, Accounting for Stock-Based Compensation. Under the modified prospective transition method selected by the Company under the provisions of SFAS 148, Accounting for Stock-Based Compensation Transition and Disclosure, compensation costs related to stock options are reflected in net income. See Notes 4 and 25 for further discussions regarding the methodology utilized in recognizing employee stock compensation expense.

INVESTMENT MANAGEMENT SERVICES OPERATIONS Investment management services (IMS) results are comprised of net investment income, fee income, expenses and gains and losses related to the Company s investment agreement, medium-term note and conduit programs and asset management advisory and administrative services. Fees related to asset management services are recognized in earnings as such services are performed.

MUNICIPAL SERVICES OPERATIONS Municipal services results are comprised of the net investment income, operating revenues, expenses and gains and losses of MBIA MuniServices Company and its subsidiaries. Operating revenues primarily consist of fees, which are recognized in earnings as the related services are performed.

CORPORATE Corporate results consist of net investment income, interest expense on MBIA Inc. debt and general corporate expenses. All legal and consulting costs associated with the investigations by the SEC, the NYAG and the NYSID are expensed as incurred.

GAINS AND LOSSES Net realized gains and losses are primarily generated from the sale of investments. Realized losses also include amounts resulting from the write-down of assets for which a decline in fair value below the Company s carry value is determined to be other than

temporary. Net gains and losses on derivative instruments and foreign exchange are the result of fair valuing the Company s derivative instruments and gains and losses resulting from revaluing transactions denominated in foreign currencies.

Table of Contents

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

MBIA Inc. and Subsidiaries

FOREIGN CURRENCY TRANSLATION Assets and liabilities denominated in foreign currencies are translated at year-end exchange rates. Operating results are translated at average rates of exchange prevailing during the year. Unrealized gains or losses, net of deferred taxes, resulting from translation are included in accumulated other comprehensive income in shareholders equity. Gains and losses resulting from transactions in foreign currencies are recorded in current earnings.

INCOME TAXES Deferred income taxes are provided with respect to the temporary differences between the tax bases of assets and liabilities and the reported amounts in the financial statements that will result in deductible or taxable amounts in future years when the reported amounts of assets and liabilities are recovered or settled. Such temporary differences relate principally to premium revenue recognition, deferred acquisition costs, unrealized appreciation or depreciation of investments and derivatives, and MBIA Corp. s statutory contingency reserve.

The Internal Revenue Code permits companies writing financial guarantee insurance to deduct from taxable income amounts added to the statutory contingency reserve, subject to certain limitations. The tax benefits obtained from such deductions must be invested in non-interest-bearing U.S. Government tax and loss bonds. The Company records purchases of tax and loss bonds as payments of federal income taxes. The amounts deducted must be restored to taxable income when the contingency reserve is released, at which time the Company may present the tax and loss bonds for redemption to satisfy the additional tax liability.

NOTE 4: RECENT ACCOUNTING PRONOUNCEMENTS

In November 2005, the FASB issued FASB Staff Position (FSP) 115-1, The Meaning of Other-Than-Temporary Impairment and its Application to Certain Investments, which nullifies certain requirements of EITF 03-1, The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments and amends SFAS 115 and Accounting Principles Board Opinion (APB) 18, The Equity Method of Accounting for Investments in Common Stocks. FSP 115-1 outlines a three-step model to identify investment impairments in each reporting period. First, for each reporting period, individual securities are determined to be impaired if the fair value of a security is less than its cost. Second, impaired securities are evaluated as to whether the impairment is other than temporary based on existing applicable guidance. Lastly, if the impairment is other than temporary, an impairment loss is recognized in earnings equal to the difference between the investment s cost and fair value as of the reporting date. Under FSP 115-1, the disclosure requirements required by EITF 03-1 issued in December 2003 remain in effect. EITF 03-1 requires the Company to disclose certain information about unrealized losses on its investment portfolio that have not been recognized as other-than-temporary impairments. The requirements under FSP 115-1 are effective for reporting periods beginning after December 15, 2005. The Company believes that the adoption of FSP 115-1 will not have a material effect on the Company s financial position or results of operations. See Note 12 for disclosures required by EITF 03-1.

In December 2004, the FASB issued SFAS 123(R), Share-Based Payment. SFAS 123(R) is a revision of SFAS 123 and supersedes APB 25, Accounting for Stock Issued to Employees. SFAS 123(R) requires the Company to expense the fair value of employee stock options and other forms of stock-based compensation. In addition, SFAS 123(R) classifies share-based payment awards as either liability awards, which are remeasured at fair value at each balance sheet date, or equity awards, which are measured at fair value on the grant date and not subsequently remeasured. Generally, awards with cash-based settlement, repurchase features or that are settled at a fixed dollar amount are classified as liability awards, and changes in fair value will be reported in earnings. Awards with net-settlement features or that permit a cashless exercise with third-party brokers are classified as equity awards and changes in fair value are not reported in earnings. The requirements are effective for the Company as of January 1, 2006. The Company s long-term incentive plans include features which would result in both liability and equity awards. The Company adopted the fair value provisions of SFAS 123 effective January 1, 2002 and does not believe that the adoption of SFAS 123(R) for equity awards will have a material effect on the Company s financial position or results of operations. For liability awards, the Company currently remeasures these awards and does not believe that the adoption of SFAS 123(R) will have a material effect on the Company s financial position or results of operations.

In April 2003, the FASB issued SFAS 149, Amendment of Statement 133 on Derivative Instruments and Hedging Activities. SFAS 149 amends and clarifies financial accounting and reporting for derivative instruments, including certain derivative instruments embedded in other contracts and for hedging activities under SFAS 133. SFAS 149 amends SFAS 133 for decisions made as part of the Derivatives Implementation Group process that effectively required amendments to SFAS 133, decisions made in connection with other FASB projects dealing with financial instruments and in connection with implementation issues raised in relation to the application of the definition of a derivative. SFAS 149 is effective for contracts entered into or modified after June 30, 2003 and for hedging relationships designated after June 30, 2003. The Company s financial position and results of operations did not change as a result of the adoption of SFAS 149.

76

Table of Contents

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

MBIA Inc. and Subsidiaries

In January 2003, the FASB issued FIN 46, which was revised in December 2003 as FIN 46(R), as an interpretation of Accounting Research Bulletin No. (ARB) 51, Consolidated Financial Statements. FIN 46(R) addresses consolidation of VIEs by business enterprises. An entity is considered a VIE subject to consolidation if the equity investment at risk is not sufficient to permit the entity to finance its activities without additional subordinated financial support or if the equity investors lack one of three characteristics of a controlling financial interest. First, the equity investors lack the ability to make decisions about the entity s activities through voting rights or similar rights. Second, they do not bear the obligation to absorb the expected losses of the entity if they occur. Lastly, they do not claim the right to receive expected returns of the entity if they occur, which is the compensation for the risk of absorbing the expected losses. MBIA determined that FIN 46(R) applies to entities that it sponsors and, in certain cases, unaffiliated entities that it guarantees. See Note 6 for a further discussion on the impact of adoption of FIN 46(R) on the Company s financial statements.

NOTE 5: GOODWILL

Goodwill totaled $79.4 million as of December 31, 2005 and 2004, of which $76.9 million was within the insurance reporting segment and $2.5 million was within the investment management services reporting segments. As a result of the sale of the assets of 1838 Investment Advisors, LLC (1838) in May 2004, goodwill within the investment management services operations declined by $10.6 million during 2004.

The Company performed its annual impairment testing of goodwill as of January 1, 2005 and January 1, 2006. On both dates, the fair values of the insurance reporting segment and the investment management services reporting segment exceeded their carrying values indicating that goodwill was not impaired. In performing this evaluation, the Company determined that the best measure of the fair value of the insurance reporting segment was its book value adjusted for the after-tax effects of net deferred premium revenue less deferred acquisition costs, the present value of installment premiums and a provision for losses to arrive at adjusted book value. Adjusted book value is a common measure used by analysts to determine the value of financial guarantee companies. For the investment management services reporting segment, the fair value was determined using a multiple of earnings before income tax, depreciation and amortization (EBITDA), as this is a common measure of fair value in the investment management industry.

NOTE 6: VARIABLE INTEREST ENTITIES

The Company provides structured funding and credit enhancement services to global finance clients through the use of certain MBIA-administered, bankruptcy-remote special purpose vehicles (SPVs) and through third-party SPVs. The purpose of the MBIA-administered SPVs is to provide clients with an efficient source of funding, which may offer MBIA the opportunity to issue financial guarantee insurance policies. These SPVs purchase various types of financial instruments, such as debt securities, loans, lease receivables and trade receivables, and fund these purchases through the issuance of asset-backed short-term commercial paper or medium-term notes. The assets and liabilities within the medium-term note programs are managed primarily on a match-funded basis and may include the use of derivative hedges, such as interest rate and foreign currency swaps. By match-funding, the SPVs eliminate the risks associated with fluctuations in interest and foreign currency rates, indices and liquidity. Typically, programs involve the use of rating agencies in assessing the quality of asset purchases and in assigning ratings to the various programs. In general, asset purchases at the inception of a program are required to be investment grade by at least one major rating agency. The primary SPVs administered by MBIA are Triple-A One Funding Corporation (Triple-A), Meridian Funding Company, LLC (Meridian) and Polaris Funding Company, LLC (Polaris) (collectively, the Conduits). Third-party SPVs are used in a variety of structures guaranteed or managed by MBIA, whereby the Company has risks analogous to those of MBIA-administered SPVs. The Company has determined that such SPVs fall within the definition of a VIE under FIN 46(R).

Under the provisions of FIN 46(R), an entity is considered a VIE subject to consolidation if the equity investment at risk is not sufficient to permit the entity to finance its activities without additional subordinated financial support or if the equity investors lack one of three characteristics of a controlling financial interest. First, the equity investors lack the ability to make decisions about the entity s activities through voting rights or similar rights. Second, they do not bear the obligation to absorb the expected losses of the entity if they occur. Lastly, they do not claim the right to receive expected returns of the entity if they occur, which is the compensation for the risk of absorbing the expected losses. A VIE is consolidated with its primary beneficiary, which is the entity that will absorb the majority of the expected losses, receive the majority of the expected residual returns, or both, of the VIE.

On September 30, 2003, prior to the applicable effective date of FIN 46(R), MBIA purchased the equity and acquired all controlling interests of the Conduits and began consolidating them in the financial statements of the Company. The Conduits fall within the scope of FIN 46(R) and continue to be consolidated by the Company. The conduit segment within the Company s investment management services operations is principally comprised of the activities of these entities. MBIA has included on its balance sheet the assets and liabilities of each Conduit, which consist primarily of various types of investments and medium-term

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

MBIA Inc. and Subsidiaries

notes and commercial paper, and has included in its income statement the operating revenues and expenses of the Conduits subsequent to their acquisition date. Certain of MBIA s consolidated subsidiaries have invested in Conduit debt obligations or have received compensation for services provided to the Conduits. As such, MBIA has eliminated intercompany transactions with the Conduits from its balance sheet and income statement. After the elimination of such intercompany assets and liabilities, Conduit total assets and liabilities were $4.6 billion and $4.4 billion, respectively, at December 31, 2005 and $7.0 billion and $6.7 billion, respectively, at December 31, 2004.

In 2004, the Company consolidated two VIEs established in connection with the securitization of Capital Asset tax liens. As a result of a clean-up call exercised for the Capital Asset Research Funding Series 1997A and Series 1998A tax lien securitizations, these securitizations no longer met the conditions of a qualifying special purpose entity under SFAS 140. MBIA holds a variable interest in these entities, which resulted from its insurance policies, and has determined that it is the primary beneficiary under FIN 46(R). MBIA has reported the assets of the securitizations, totaling $2.5 million and $16.8 million at December 31, 2005 and December 31, 2004, respectively, principally within Other assets on its consolidated balance sheet. Liabilities of the securitizations substantially represented amounts due to MBIA, which were eliminated in consolidation.

In addition to MBIA-administered SPVs, MBIA must determine whether it has variable interests in third-party VIEs and if so, whether those variable interests would cause MBIA to be the primary beneficiary and, therefore, consolidate such entities. Under FIN 46(R), MBIA s guarantee of the assets or liabilities of a VIE constitute a variable interest and require MBIA to assess whether it is the primary beneficiary. Consolidation of such VIEs does not increase MBIA s exposure above that already committed to in its insurance policies. The Company has consolidated third-party VIEs as a result of guarantees provided by its insurance operations. Third-party VIEs assets and liabilities are primarily reported in Investments held-to-maturity and Variable interest entity floating rate notes , respectively, on the face of the Company s balance sheet. The assets and liabilities of these VIEs each totaled $1.3 billion at December 31, 2005 and $600.5 million at December 31, 2004. Third-party VIEs creditors do not have recourse to the general assets of MBIA outside of the financial guarantee policy provided to the VIEs.

NOTE 7: DERIVATIVE INSTRUMENTS

MBIA enters into derivative transactions as an additional form of financial guarantee and for purposes of hedging risks associated with existing assets and liabilities and forecasted transactions. The Company accounts for derivative transactions in accordance with SFAS 133, as amended, which requires that all such transactions be recorded on the Company s balance sheet at fair value. Changes in the fair value of derivatives are recorded each period in current earnings within Net gains (losses) on derivative instruments and foreign exchange or in shareholders equity within Accumulated other comprehensive income, depending on whether the derivative is designated as a hedge, and if so designated, the type of hedge.

INSURANCE The Company has entered into derivative transactions that it views as an extension of its core financial guarantee business but do not qualify for the financial guarantee scope exception under SFAS 133 and, therefore, must be stated at fair value. The insurance operations, which represent the majority of the Company s notional derivative exposure, have insured derivatives primarily consisting of structured pools of credit default swaps that the Company intends to hold for the entire term of the contract. The insurance operations have also provided guarantees on the value of certain structured closed-end funds, which meet the definition of a derivative under SFAS 133. The Company reduces risks embedded in its insured portfolio by entering into derivative transactions or other types of hedging arrangements. These arrangements may include reinsurance agreements and capital markets transactions in which the Company hedges a portion of the credit and market risk associated with its insured credit derivative portfolio. Premiums received on insured derivatives are recorded as part of premiums earned. Additionally, changes in fair values of derivative transactions within MBIA s insurance operations are recorded in current earnings.

INVESTMENT MANAGEMENT SERVICES The investment management services operations have entered into derivative transactions primarily consisting of interest rate, cross currency, credit default and total return swaps and principal protection guarantees. Interest rate swaps are entered into to hedge the risks associated with fluctuations in interest rates or fair values of certain contracts. Cross currency swaps are entered into to hedge the variability in cash flows resulting from fluctuations in foreign currency rates. Credit default swaps are entered into to hedge credit risk or to replicate investments in cash assets consistent with the Company s risk objectives and credit guidelines for its investment management business. The maximum amount of future payments the Company may be required to make under credit default swap contracts, should a full credit event occur on all of its outstanding contracts, is $1.6 billion. These credit default swaps reference credits with an average quality of AA-/Aa3 and have a maturity range of 1 5 years. In accordance with SFAS 133, the fair values of these credit default swaps at December 31, 2005 are recorded on the consolidated balance sheet as assets and liabilities, representing gross gains and losses, of $5.2 million

and $17 thousand, respectively. Total return swaps are entered into to enable the Company to earn returns on certain obligations without directly owning

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

MBIA Inc. and Subsidiaries

the underlying obligations. The Company has also provided loss protection on certain MBIA-MISC managed municipal pools that invest in highly rated short-term fixed-income securities. Such protection is accounted for as a derivative under SFAS 133 and is included as part of the Company s principal protection guarantees.

Certain interest rate and cross currency swaps qualify as cash flow hedges and fair value hedges under SFAS 133. The cash flow hedges mitigate or offset fluctuations in cash flows arising from variable rate assets or liabilities. The unrealized gains and losses relating to the cash flow hedges are reported in accumulated other comprehensive income and will be reclassified into earnings as interest revenue and expense are recognized on the hedged assets and liabilities. The fair value hedges are used to protect against changes in the market value of the hedged assets or liabilities. The gains and losses relating to the fair value hedges are recorded directly in earnings. Cash flow and fair value hedges are hedging existing assets, liabilities or forecasted transactions. During 2005, the Company recorded gains of $.9 million (net of tax) and losses of $19 thousand (net of tax) in earnings within net gains (losses) on derivative instruments and foreign exchange due to the ineffectiveness of fair value and cash flow hedges, respectively.

The Conduits primarily enter into interest rate and cross currency swaps as economic hedges against interest rate and currency risks. The cross currency swaps qualify as fair value hedges of foreign currency risk under SFAS 133. During 2005, the Company recorded gains of $1.7 million (net of tax) in earnings due to the ineffectiveness of these hedges. The Company also recorded gains of $12.4 million (net of tax) on economic hedges that did not qualify for hedge accounting under SFAS 133.

Cash flow hedges related to the investment management services operations resulted in an aggregate net unrealized gain of $4.2 million (net of tax) in accumulated other comprehensive income at December 31, 2005. The aggregate net unrealized gain is composed of both positive and negative future cash flows. The Company expects that approximately $.8 million of unrealized gains (net of tax) will migrate from accumulated other comprehensive income into earnings during 2006 and the remaining amount over the term of the contracts.

MUNICIPAL SERVICES Capital Asset entered into an interest rate collar to economically hedge interest rate risk on a floating rate note. The change in the fair value of the collar is recorded each period in earnings, as the collar is not a qualifying hedge under SFAS 133.

CORPORATE The corporate operations has entered into a cross currency swap to hedge foreign exchange risks related to the issuance of certain MBIA long-term debt in accordance with the Company s risk management policies. The cross currency swap has been designated as a cash flow hedge and hedges the variability arising from currency exchange rate movements on the foreign denominated fixed rate debt. Changes in the fair value of the cross currency swap are recorded in accumulated other comprehensive income. As the debt is revalued at the spot exchange rate in accordance with SFAS 52, Foreign Currency Translation, an amount that will offset the related transaction gain or loss arising from the revaluation will migrate each period from accumulated other comprehensive income into earnings. This cash flow hedge was 100% effective during 2005.

The cross currency swap resulted in an aggregate unrealized gain of $1.8 million (net of tax) remaining in accumulated other comprehensive income at December 31, 2005. The Company expects that approximately $1.0 million of unrealized losses (net of tax) will migrate from accumulated other comprehensive income into earnings during 2006 and the remaining balance over the term of the contract.

Table of Contents

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

MBIA Inc. and Subsidiaries

The notional values of the derivative instruments, net of reinsurance contracts where applicable, by business operations for the years ended December 31, 2005 and 2004 are as follows:

	Year ended December 31, 2005				
In millions	**Insurance**	**Investment Management Services**	**Municipal Services**	**Corporate**	**Total**
Credit default swaps	$ 77,112	$ 1,662	$	$	$ 78,774
Interest rate swaps		14,124			14,124
Principal protection guarantees	1,955	2,654			4,609
Currency swaps		3,894		133	4,027
Total return swaps	331	608			939
Credit linked notes	295	200			495
Interest rate caps/floors		450	4		454
All other		95			95
Total	$ 79,693	$ 23,687	$ 4	$ 133	$ 103,517

	Year ended December 31, 2004				
In millions	**Insurance**	**Investment Management Services**	**Municipal Services**	**Corporate**	**Total**
Credit default swaps	$ 80,093	$ 1,122	$	$	$ 81,215
Interest rate swaps		10,783			10,783
Principal protection guarantees	2,514	2,226			4,740
Currency swaps		3,476		154	3,630
Total return swaps	377	779			1,156
Credit linked notes	800	100			900
Interest rate caps/floors		450	6		456
All other		94			94
Total	$ 83,784	$ 19,030	$ 6	$ 154	$ 102,974

The Company manages counterparty credit risk on an individual counterparty basis through master netting agreements covering derivative transactions in the investment management services, municipal services and corporate operations. These agreements allow the Company to contractually net amounts due from a counterparty with those amounts due to such counterparty when certain triggering events occur. The Company only executes swaps under master netting agreements, which typically contain mutual credit downgrade provisions that generally provide the ability to require assignment or termination in the event either MBIA or the counterparty is downgraded below a specified credit rating. If the Company were to settle all transactions covered under netting agreements as of December 31, 2005, the amount required to be paid to counterparties would have been reduced by $173.4 million as a result of its contractual right to offset amounts due from such counterparties. The Company has chosen not to net receivables due from counterparties with payables due to counterparties in its balance sheet, but instead report these amounts on a gross basis as assets and liabilities.

In certain cases, the Company also manages credit risk through collateral agreements that give the Company the right to hold or the obligation to provide collateral when the current market value of certain derivative contracts exceeds an exposure threshold. Under these arrangements, the Company may receive or provide U.S. Treasury and other highly rated securities or cash to secure counterparties exposure to the Company or its exposure to counterparties, respectively. Such collateral is available to the holder to

Table of Contents

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

MBIA Inc. and Subsidiaries

pay for replacing the counterparty in the event that the counterparty defaults. As of December 31, 2005, no securities or cash were held or placed by the Company under these agreements.

FINANCIAL STATEMENT IMPACT As of December 31, 2005 and 2004, the Company held derivative assets of $326.9 million and $288.6 million, respectively, and derivative liabilities of $384.6 million and $527.5 million, respectively, which are shown separately on the consolidated balance sheets. The following tables display the amount of the derivative assets and liabilities by business operations for the years ended December 31, 2005 and 2004.

	Year ended December 31, 2005				
In millions	Insurance	Investment Management Services	Municipal Services	Corporate	Total
Derivative assets	$ 40.3	$ 250.2	$	$ 36.4	$ 326.9
Derivative liabilities	$ 32.1	$ 352.5	$	$	$ 384.6

	Year ended December 31, 2004				
In millions	Insurance	Investment Management Services	Municipal Services	Corporate	Total
Derivative assets	$ 39.8	$ 191.9	$	$ 56.9	$ 288.6
Derivative liabilities	$ 25.3	$ 501.9	$ 0.3	$	$ 527.5

The income statement impact for all derivative transactions for 2005 was an after-tax increase in net income of $77.9 million. The impact of all derivative transactions for 2004 and 2003 was an after-tax increase in net income of $32.1 million and $95.5 million, respectively. The income statement impact of derivative activity is broken down into revenues, net realized gains (losses), net gains (losses) on derivative instruments and foreign exchange and expenses. Interest and fee income, including premiums received on insured derivatives, and interest and fee expense on derivatives are recorded within revenues and expenses. For derivatives that have been designated as qualifying hedges, income and expense are recorded as an adjustment to those of the hedged items. The following tables display the impact described above on the 2005, 2004 and 2003 income statements by business operation of all derivative transactions.

Table of Contents

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

MBIA Inc. and Subsidiaries

		Year ended December 31, 2005			
		Investment Management	Municipal		
In millions	Insurance	Services	Services	Corporate	Total
Revenues*	$ 73.2	$ 22.7	$	$	$ 95.9
Net realized gains (losses)		(4.5)			(4.5)
Net gains (losses) on derivative instruments and foreign exchange:					
Credit derivatives	(6.3)	(0.9)			(7.2)
Ineffectiveness on hedges		4.1			4.1
Economic hedges		41.3	0.2		41.5
Total revenues	66.9	62.7	0.2		129.8
Expenses*	(8.6)		(0.1)	(1.2)	(9.9)
Income (loss) before income taxes	58.3	62.7	0.1	(1.2)	119.9
Tax (provision) benefit	(20.4)	(22.0)		0.4	(42.0)
Net income (loss)	$ 37.9	$ 40.7	$ 0.1	$ (0.8)	$ 77.9

		Year ended December 31, 2004			
		Investment Management	Municipal		
In millions	Insurance	Services	Services	Corporate	Total
Revenues*	$ 68.9	$ (6.0)	$	$	$ 62.9
Net realized gains (losses)		(0.8)			(0.8)
Net gains (losses) on derivative instruments and foreign exchange:					
Credit derivatives	6.6	1.9			8.5
Ineffectiveness on hedges		(10.5)			(10.5)
Economic hedges		(1.1)	(0.3)		(1.4)
Total revenues	75.5	(16.5)	(0.3)		58.7
Expenses*	(8.0)		(0.2)	(1.2)	(9.4)
Income (loss) before income taxes	67.5	(16.5)	(0.5)	(1.2)	49.3
Tax (provision) benefit	(23.6)	5.8	0.2	0.4	(17.2)
Net income (loss)	$ 43.9	$ (10.7)	$ (0.3)	$ (0.8)	$ 32.1

Table of Contents

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

MBIA Inc. and Subsidiaries

	Year ended December 31, 2003				
In millions	Insurance	Investment Management Services	Municipal Services	Corporate	Total
Revenues*	$ 51.0	$ 5.5	$	$ 0.8	$ 57.3
Net realized gains (losses)		0.7			0.7
Net gains (losses) on derivative instruments and foreign exchange:					
Credit derivatives	104.0	8.1			112.1
Ineffectiveness on hedges		(7.4)			(7.4)
Economic hedges		(9.7)			(9.7)
Total revenues	155.0	(2.8)		0.8	153.0
Expenses*	(6.0)				(6.0)
Income (loss) before income taxes	149.0	(2.8)		0.8	147.0
Tax (provision) benefit	(52.2)	1.0		(0.3)	(51.5)
Net income (loss)	$ 96.8	$ (1.8)	$	$ 0.5	$ 95.5

* Includes premiums earned, advisory fees and losses incurred in the insurance operations and interest income and expenses in the investment management services and corporate operations.

At December 31, 2005, the Company reported an accumulated unrealized gain of $6.0 million (net of tax) in other comprehensive income related to the fair value of the cash flow hedges compared to a $3.3 million unrealized gain (net of tax) at December 31, 2004. The change resulted from a $2.3 million after-tax unrealized gain in the fair value of the cash flow hedges and the transfer of $.5 million of after-tax net expense to earnings as a result of scheduled interest payments and receipts on the cash flow hedges. At December 31, 2005, the maximum term of derivative instruments that hedge forecasted transactions was approximately 13 years.

The fair value of the Company s derivative instruments is estimated using various valuation models that conform to industry standards. The Company utilizes both vendor-developed and proprietary models, based on the complexity of transactions. Dealer market quotes are typically obtained for regularly traded contracts and provide the best estimate of fair value. However, when reliable dealer market quotes are not available, the Company uses a variety of market and portfolio data relative to the type and structure of contracts. Several of the more significant types of data that influence the Company s valuation models include interest rates, credit quality ratings, credit spreads, default probabilities and diversity scores. This data is obtained from highly recognized sources and is reviewed for reasonableness and applicability to the Company s derivative portfolio.

The use of market data requires management to make assumptions on how the fair value of derivative instruments is affected by current market conditions. Therefore, results can significantly differ between models and due to changes in management assumptions. The Company has dedicated resources to the development and ongoing review of its valuation models and has instituted procedures for the approval and control of data inputs. In addition, regular reviews are performed to ensure that the Company s valuation models are appropriate and produce values reflective of the current market environment. In 2003, the Company added an additional third-party data source for generic credit spread information used by the Company in its valuation process to avoid undue reliance on any single data vendor, as well as to enhance its assessment of fair values. In 2004 and 2005, there were no significant changes to the valuation process.

NOTE 8: TRANSFERS AND SERVICING OF FINANCIAL ASSETS AND EXTINGUISHMENTS OF LIABILITIES

The Company enters into securities borrowing and lending contracts in connection with MBIA s collateralized investment and repurchase agreement activities and to invest short-term cash balances or provide liquidity to the Company s asset/liability programs. Such contracts are only

transacted with high quality dealer firms. It is the Company s policy to take possession of securities borrowed under these contracts.

The Company minimizes the credit risk of counterparties to transactions that might be unable to fulfill their contractual obligations by monitoring customer credit exposure and collateral value and requiring additional collateral to be deposited with the Company when deemed necessary.

SFAS 140 requires the Company to reclassify financial assets pledged as collateral under certain agreements and to report those assets at fair value as a separate line item on the balance sheet. At December 31, 2005 and 2004, the fair values of financial assets pledged as collateral under securities borrowing contracts were $729 million and $731 million, respectively.

83

Table of Contents

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

MBIA Inc. and Subsidiaries

NOTE 9: EARNINGS PER SHARE

Basic earnings per share excludes dilution and is computed by dividing income available to common shareholders by the weighted-average number of common shares outstanding during the period. Diluted earnings per share shows the dilutive effect of all stock options and other items outstanding during the period that could potentially result in the issuance of common stock. As of December 31, 2005, 2004 and 2003 there were 2,837,793, 2,294,297 and 5,606,205 stock options, respectively, that were not included in the diluted earnings per share calculation because they were antidilutive.

The following table sets forth the computation of basic and diluted earnings per share for the years ended December 31, 2005, 2004 and 2003:

	Years ended December 31		
In thousands except per share amounts	**2005**	**2004**	**2003**
Income from continuing operations, net of tax	$ 712,079	$ 840,470	$ 823,248
Income (loss) from discontinued operations, net of tax	(1,093)	2,576	2,104
Net income	$ 710,986	$ 843,046	$ 825,352
Basic weighted-average shares	134,098,392	141,861,225	143,449,007
Effect of common stock equivalents	3,122,339	2,938,288	1,531,389
Diluted weighted-average shares	137,220,731	144,799,513	144,980,396
Basic EPS:			
Income from continuing operations	$ 5.31	$ 5.92	$ 5.74
Income (loss) from discontinued operations	(.01)	0.02	0.01
Net income	$ 5.30	$ 5.94	$ 5.75
Diluted EPS:			
Income from continuing operations	$ 5.19	$ 5.80	$ 5.68
Income (loss) from discontinued operations	(.01)	0.02	0.01
Net income	$ 5.18	$ 5.82	$ 5.69

NOTE 10: STATUTORY ACCOUNTING PRACTICES

The financial statements have been prepared on a GAAP basis, which differs in certain respects from the statutory accounting practices prescribed or permitted by the insurance regulatory authorities. Statutory accounting practices differ from GAAP in the following respects:

upfront premiums are earned on a basis proportionate to the scheduled periodic maturity of principal and payment of interest (debt service) to the original total principal and interest insured as opposed to earning in proportion to the expiration of the related risk;

acquisition costs are charged to operations as incurred rather than deferred and amortized as the related premiums are earned;

fixed-maturity investments are generally reported at amortized cost rather than fair value;

a contingency reserve is computed on the basis of statutory requirements, and reserves for losses and LAE are established at present value for specific insured issues that are identified as currently or likely to be in default. Under GAAP, reserves are established based on the Company s reasonable estimate of the identified and unallocated losses and LAE on the insured obligations it has written;

changes in net deferred income taxes are recognized as a separate component of gains and losses in surplus. Under GAAP, changes in the Company s net deferred income tax balances are recognized in net income;

the Internal Revenue Service permits financial guarantee insurance companies a deduction for increases to the statutory contingency reserve resulting in the purchase of tax and loss bonds equal to the tax benefit derived. Tax and loss bonds purchased are recorded as admitted assets and credited to surplus. Contingency reserves are not permitted under GAAP;

the acquisitions of MBIA Corp. and MBIA Illinois were recorded at statutory book value. Therefore, no goodwill was recorded. Under GAAP, goodwill represents the excess of the cost of acquisitions over the fair value of the net assets acquired;

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

MBIA Inc. and Subsidiaries

derivative assets and liabilities exclude insurance guarantees, while under GAAP, guarantees that do not qualify for the financial guarantee scope exception under SFAS 133 are recorded at fair value; and

certain assets designated as non-admitted assets are charged directly against surplus but are reflected as assets under GAAP. Consolidated net income of MBIA Corp. determined in accordance with statutory accounting practices for the years ended December 31, 2005, 2004 and 2003 was $633.0 million, $768.5 million and $669.2 million, respectively.

The following is a reconciliation of consolidated shareholders equity presented on a GAAP basis for the Company and its consolidated subsidiaries to statutory capital and surplus for MBIA Corp. and its subsidiaries:

In thousands	As of December 31 2005	As of December 31 2004
Company s GAAP shareholders equity	$ 6,591,644	$ 6,558,797
Non-insurance segment assets and liabilities, net	303,525	225,804
Premium revenue recognition	(730,541)	(670,765)
Deferral of acquisition costs	(427,111)	(406,035)
Investments, including unrealized gains	(443,776)	(894,834)
Contingency reserve	(2,768,992)	(2,705,147)
Unallocated loss and LAE reserves	344,755	290,460
Deferred income tax liabilities, net	512,542	619,273
Tax and loss bonds	455,824	394,717
Goodwill	(76,938)	(76,938)
Derivative assets and liabilities	(8,289)	(14,506)
Non-admitted assets	(45,671)	(51,038)
Other items	93,427	10,483
Statutory capital and surplus	$ 3,800,399	$ 3,280,271

The NYSID recognizes only statutory accounting practices prescribed or permitted by the State of New York and the NYSID has adopted the National Association of Insurance Commissioners (NAIC) Accounting Practices and Procedures Manual as a component of the NYSID s prescribed or permitted practices.

The NYSID does not allow goodwill to be an admitted asset, while the NAIC requires goodwill recognition. At December 31, 2005 and 2004, MBIA Corp. has reduced admitted assets by $76.9 million related to goodwill. The NYSID prescribes discounting of case basis loss reserves. Incurred losses and LAE include amounts discounted at 5.0% and 4.8% for 2005 and 2004, respectively. The discount for 2005 was $28.1 million and for 2004 was $37.6 million. NYSID prescribed procedure enables MBIA Corp. to account for Channel Reinsurance Ltd. (Channel Re), a Triple-A rated financial guarantee reinsurance company in which MBIA Corp. holds a 17.4% ownership interest, as other investments rather than as an affiliate. The NYSID prescribes the treatment of estimated lease receipts related to a paid loss as a non-admitted asset, while the NAIC requires these anticipated receipts to offset loss reserves. As of December 31, 2005 and 2004, MBIA Corp. has reduced admitted assets by $22.2 million and $34.4 million, respectively.

NOTE 11: PREMIUMS EARNED FROM REFUNDED AND CALLED BONDS

When an MBIA-insured issue is retired early, is called by the issuer, or is in substance paid in advance through a refunding accomplished by placing U.S. Government securities in escrow, the remaining deferred premium revenue is earned at that time since there is no longer risk to the Company. Premiums earned, after reinsurance, include $140.5 million, $143.4 million and $130.4 million for 2005, 2004 and 2003, respectively, related to refunded and called MBIA-insured bonds.

NOTE 12: INVESTMENTS

The Company s investment objective is to optimize long-term, after-tax returns while emphasizing the preservation of capital through maintenance of high quality investments with adequate liquidity. The Company s investment policies limit the amount of credit exposure to any one issuer. The fixed-maturity portfolio is comprised of high quality (average rating Aa) taxable and tax-exempt investments of diversified maturities.

Table of Contents

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

MBIA Inc. and Subsidiaries

The following tables set forth the amortized cost and fair value of the available-for-sale fixed-maturity and short-term investments included in the consolidated investment portfolio of the Company as of December 31, 2005 and 2004:

In thousands	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
As of December 31, 2005				
Taxable bonds:				
United States Treasury and government agency	$ 557,270	$ 17,232	$ (4,787)	$ 569,715
Foreign governments	621,364	39,677	(2,716)	658,325
Corporate and other obligations	16,309,834	426,446	(86,219)	16,650,061
Mortgage-backed	2,725,206	10,487	(34,652)	2,701,041
Tax-exempt bonds:				
State and municipal obligations	5,366,345	216,240	(7,170)	5,575,415
Total	$ 25,580,019	$ 710,082	$ (135,544)	$ 26,154,557

In thousands	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
As of December 31, 2004				
Taxable bonds:				
United States Treasury and government agency	$ 690,741	$ 33,876	$ (662)	$ 723,955
Foreign governments	495,736	47,153	(2,292)	540,597
Corporate and other obligations	13,522,517	517,809	(27,217)	14,013,109
Mortgage-backed	2,426,051	28,357	(8,470)	2,445,938
Tax-exempt bonds:				
State and municipal obligations	4,786,745	306,463	(840)	5,092,368
Total	$ 21,921,790	$ 933,658	$ (39,481)	$ 22,815,967

Fixed-maturity investments carried at fair value of $12.9 million and $13.8 million as of December 31, 2005 and 2004, respectively, were on deposit with various regulatory authorities to comply with insurance laws.

A portion of the obligations under investment agreements require the Company to pledge securities as collateral. As of December 31, 2005 and 2004, the fair value of securities pledged as collateral with respect to these obligations approximated $4.6 billion and $3.6 billion, respectively.

The following table sets forth the distribution by contractual maturity of the available-for-sale fixed-maturity and short-term investments at amortized cost and fair value at December 31, 2005. Contractual maturity may differ from expected maturity because borrowers may have the right to call or prepay obligations.

In thousands	Amortized Cost	Fair Value
Within 1 year	$ 1,457,190	$ 1,457,190
Beyond 1 year but within 5 years	5,418,781	5,421,816
Beyond 5 years but within 10 years	5,769,642	5,880,556
Beyond 10 years but within 15 years	2,663,365	2,828,374
Beyond 15 years but within 20 years	1,425,107	1,529,474
Beyond 20 years	6,065,445	6,280,130
Mortgage-backed	2,780,489	2,757,017
Total fixed-maturity and short-term investments	$ 25,580,019	$ 26,154,557

Table of Contents

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

MBIA Inc. and Subsidiaries

Investments that are held-to-maturity are reported on the Company s balance sheet at amortized cost. These investments, which relate to the Company s Conduit program and consolidated VIEs, primarily consist of asset-backed securities and loans issued by major national and international corporations and other structured finance clients. The following table sets forth the distribution of held-to-maturity investments by contractual maturity at amortized cost and fair value at December 31, 2005.

In thousands	Amortized Cost	Fair Value
Within 1 year	$	$
Beyond 1 year but within 5 years	3,094,214	3,072,261
Beyond 5 years but within 10 years	834,360	825,466
Beyond 10 years but within 15 years	23,333	23,333
Beyond 15 years but within 20 years		
Beyond 20 years	902,022	902,022
Mortgage-backed	911,253	911,253
Total held-to-maturity investments	$ 5,765,182	$ 5,734,335

Included in the preceding tables are investments that have been insured by MBIA Corp. (MBIA Insured Investments). At December 31, 2005, MBIA Insured Investments, at fair value, represented $8.8 billion or 28% of the total portfolio, of which $4.5 billion or 14% relate to Conduit investments. Without giving effect to the MBIA guarantee of the MBIA Insured Investments, the underlying ratings (those given to an investment without the benefit of MBIA s guarantee) of the MBIA Insured Investments as of December 31, 2005 are reflected in the following table. Amounts represent the fair value of such investments including the benefit of the MBIA guarantee. The ratings in the table below are the lower underlying rating assigned by S&P or Moody s when an underlying rating exists from either rating service, or when an external underlying rating is not available, the underlying rating is based on the Company s best estimate of the rating of such investment.

Underlying Ratings Scale In thousands	Insurance Portfolio	Investment Management Services Portfolio	Investments Held-to-Maturity	Total
Aaa	$ 9,716	$ 478,784	$ 213,502	$ 702,002
Aa	233,642	209,400	432,254	875,296
A	624,185	965,835	1,811,929	3,401,949
Baa	285,871	1,291,230	1,998,039	3,575,140
Below investment grade	107,047	155,198		262,245
Total	$ 1,260,461	$ 3,100,447	$ 4,455,724	$ 8,816,632

It is MBIA s policy to obtain an underlying rating from both Moody s and S&P for each new Conduit transaction prior to the execution of such transactions. All transactions currently funded in the Conduits have an underlying rating of investment grade by Moody s and S&P prior to funding. The weighted-average underlying rating for transactions currently funded in the Conduits was A- by S&P and A3 by Moody s at the time such transactions were funded. MBIA estimates that the weighted-average underlying rating of all outstanding Conduit transactions was A-

by S&P and A3 by Moody s as of December 31, 2005.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

MBIA Inc. and Subsidiaries

The following table sets forth the gross unrealized losses included in accumulated other comprehensive income as of December 31, 2005 related to available-for-sale fixed-maturity and equity investments. The table segregates investments that have been in a continuous unrealized loss position for less than 12 months from those that have been in a continuous unrealized loss position for twelve months or longer.

In thousands	Less than 12 Months		12 Months or Longer		Total	
Description of Securities	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
United States Treasury and government agency	$ 268,059	$ (3,986)	$ 36,443	$ (801)	$ 304,502	$ (4,787)
Foreign governments	126,673	(2,716)			126,673	(2,716)
Corporate and other obligations	4,556,528	(64,841)	1,100,380	(21,378)	5,656,908	(86,219)
Mortgage-backed	1,320,528	(18,993)	658,203	(15,659)	1,978,731	(34,652)
State and municipal obligations	889,454	(6,648)	24,698	(522)	914,152	(7,170)
Total debt securities	7,161,242	(97,184)	1,819,724	(38,360)	8,980,966	(135,544)
Equities						
Total	$ 7,161,242	$ (97,184)	$ 1,819,724	$ (38,360)	$ 8,980,966	$ (135,544)

The following table sets forth the gross unrealized losses of the held-to-maturity investments as of December 31, 2005. Held-to-maturity investments are reported at amortized cost on the Company s balance sheet. The table segregates investments that have been in a continuous unrealized loss position for less than 12 months from those that have been in a continuous unrealized loss position for twelve months or longer.

In thousands	Less than 12 Months		12 Months or Longer		Total	
Description of Securities	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
Corporate and other obligations	$ 1,161,205	$ (6,811)	$ 1,408,395	$ (24,974)	$ 2,569,600	$ (31,785)

As of December 31, 2005, the Company s available-for-sale fixed-maturity, equity and held-to-maturity investment portfolios gross unrealized losses totaled $167.3 million. There were 244 securities that were in an unrealized loss position for a continuous twelve-month period or longer. Only two of the 244 securities had unrealized losses in which their book value exceeded market value by more than 5%. MBIA determined that the unrealized losses on these two securities were temporary in nature because there was no deterioration of credit quality spreads or a downgrade to below investment grade by at least one rating agency. Additionally, the Company has both the ability and intent to hold these investments until the value recovers to an amount at least equal to amortized cost or to maturity. See Note 13 for information on realized losses due to other-than-temporary impairments.

NOTE 13: INVESTMENT INCOME AND GAINS AND LOSSES

The following table includes total investment income from all operations. Net realized gains (losses) from investment security sales are generated as a result of the ongoing management of the Company s investment portfolios. Other investment net realized losses in 2005 of $5 million were primarily due to other-than-temporary impairment of an investment in the Company s other investment portfolio. Other investment net realized gains in 2004 were largely due to the sale of a common stock investment the Company purchased in 2002, which resulted in a $77 million gain. Other net realized losses of $27 million in 2005 include $19 million of impairment losses on receivables the Company recorded through salvage and subrogation rights it obtained as a result of claim payments it previously made on insured credits. Other net realized gains of

$41 million in 2004 resulted from the termination of certain transactions that were accounted for as deposits. Additionally, in 2005, 2004 and 2003, the Company recognized net realized losses of $3 million, $11 million and $4 million, respectively, due to other-than-temporary impairments of taxable fixed-maturity investments. In 2003, net realized gains on fixed-maturity investments were mainly the result of the Company selling securities to shorten the duration of its fixed-maturity portfolio.

Table of Contents

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

MBIA Inc. and Subsidiaries

In thousands	Years ended December 31 2005	2004	2003
Fixed-maturity	$ 1,082,498	$ 842,213	$ 746,084
Held-to-maturity	187,809	127,446	62,616
Short-term investments	51,260	20,467	17,485
Other investments	35,974	53,915	13,763
Gross investment income	1,357,541	1,044,041	839,948
Investment expenses	743,257	455,635	332,546
Net investment income	614,284	588,406	507,402
Net realized gains (losses):			
Fixed-maturity			
Gains	68,470	42,382	121,651
Losses	(44,837)	(56,392)	(43,656)
Net	23,633	(14,010)	77,995
Other investments			
Gains	4,230	81,310	6,786
Losses	(8,856)	(4,386)	(4,113)
Net	(4,626)	76,924	2,673
Other			
Gains	2,618	41,292	
Losses	(29,492)		
Net	(26,874)	41,292	
Total net realized gains (losses)	(7,867)	104,206	80,668
Total investment income	$ 606,417	$ 692,612	$ 588,070

Net unrealized gains, including related deferred income taxes, reported in accumulated other comprehensive income within shareholders equity consisted of:

In thousands	As of December 31 2005	2004
Fixed-maturity:		
Gains	$ 710,082	$ 933,658
Losses	(135,544)	(39,481)
Net	574,538	894,177
Other investments:		

Gains	28,312	47,491
Losses		(952)
Net	28,312	46,539
Total	602,850	940,716
Deferred income taxes	218,323	327,736
Unrealized gains, net	$ 384,527	$ 612,980

Table of Contents

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

MBIA Inc. and Subsidiaries

The change in net unrealized gains consisted of:

	Years ended December 31		
In thousands	**2005**	**2004**	**2003**
Fixed-maturity	$ (319,639)	$ 15,043	$ (31,916)
Other investments	(18,227)	(88,864)	131,500
Total	(337,866)	(73,821)	99,584
Deferred income tax	(109,413)	(26,944)	34,698
Change in unrealized gains, net	$ (228,453)	$ (46,877)	$ 64,886

NOTE 14: INCOME TAXES

Income from operations before provision for income taxes consisted of:

	Years ended December 31		
In thousands	**2005**	**2004**	**2003**
United States	$ 953,243	$ 1,114,125	$ 1,121,899
Non-United States	62,705	58,468	41,500
Income from continuing operations	1,015,948	1,172,593	1,163,399
Income (loss) from discontinued operations	(1,682)	(672)	3,344
Gain on sale of discontinued operations		4,722	
Income before income taxes	$ 1,014,266	$ 1,176,643	$ 1,166,743

90

Table of Contents

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

MBIA Inc. and Subsidiaries

The Company files a consolidated tax return that includes all of its U.S. subsidiaries. The effect of income taxes on income and shareholders equity is comprised of:

In thousands	Years ended December 31 2005	2004	2003
Current taxes:			
Federal	$ 231,817	$ 217,457	$ 290,002
State	734	(106)	1,215
Foreign	16,010	1,865	5,219
Deferred taxes:			
Federal	50,917	96,274	39,995
Foreign	4,391	16,633	3,720
Provision for income taxes from continuing operations	303,869	332,123	340,151
Taxes on income/(loss) from discontinued operations	(589)	(70)	1,240
Taxes on gain from sale of discontinued operations		1,544	
Total income taxes charged to income	303,280	333,597	341,391
Income taxes charged (credited) to shareholders equity:			
Unrealized (losses) gains on investment securities	(109,413)	(26,944)	34,698
Change in fair value of derivative instruments	26,862	4,055	7,127
Change in foreign currency translation	(133)	5,346	3,085
Exercise of stock options and vested restricted stock	(1,554)	(5,875)	(7,834)
Total income taxes charged (credited) to shareholders equity	(84,238)	(23,418)	37,076
Total effect of income taxes	$ 219,042	$ 310,179	$ 378,467

The provision for income taxes gives effect to permanent differences between financial and taxable income. Accordingly, the Company s effective income tax rate differs from the statutory rate on ordinary income. The reasons for the Company s lower effective tax rates are as follows:

	Years Ended December 31 2005	2004	2003
Income taxes computed on pre-tax financial income at statutory rates	35.0%	35.0%	35.0%
Increase (reduction) in taxes resulting from:			
Tax-exempt interest	(7.2)	(5.8)	(5.5)
Non-deductible costs	2.3		
Other	(0.2)	(0.8)	(0.2)
Provision for income taxes	29.9%	28.4%	29.3%

The Company recognizes deferred tax assets and liabilities for the expected future tax consequences of events that have been included in the financial statements or tax returns. Deferred tax assets and liabilities are determined based on the difference between the financial statement and tax bases of assets and liabilities using enacted tax rates in effect for the year in which the differences are expected to reverse. The effect of a change in tax rates on tax assets and liabilities is recognized in income in the period that includes the enactment date.

Table of Contents

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

MBIA Inc. and Subsidiaries

The tax effects of temporary differences that give rise to deferred tax assets and liabilities at December 31, 2005 and 2004 are presented in the following table:

In thousands	As of December 31 2005	2004
Deferred tax assets:		
Tax and loss bonds	$ 455,824	$ 394,717
Loss and loss adjustment expense reserves	73,265	101,193
Compensation and employee benefits	61,123	51,027
Other	4,006	(1,109)
Total gross deferred tax assets	594,218	545,828
Deferred tax liabilities:		
Contingency reserve	564,149	502,899
Deferred premium revenue	158,219	139,526
Deferred acquisition costs	149,488	142,112
Unrealized gains	238,881	321,565
Investments	53,017	39,353
Total gross deferred tax liabilities	1,163,754	1,145,455
Net deferred tax liability	$ 569,536	$ 599,627

The Company believes that its deferred tax assets will be fully recognized in future periods and, therefore, has not established a valuation allowance with respect to such assets.

As it is the Company s practice and intent to permanently reinvest the earnings of MBIA Assurance, S.A. and MBIA UK Insurance Limited (MBIA UK), no U.S. deferred income taxes have been provided with respect to the undistributed earnings of these entities. The cumulative amounts of such untaxed earnings were $144.4 million, $106.0 million and $67.2 million at December 31, 2005, 2004 and 2003, respectively.

On October 22, 2004, the American Jobs Creation Act of 2004 (the Act) was introduced and signed into law. The Act has a provision which allows for a special one-time dividends received deduction of 85 percent on the repatriation of certain foreign earnings to the U.S. parent, with limitations. The Company has completed its evaluation of the repatriation provision and has determined this special one-time dividend will not be claimed.

NOTE 15: BUSINESS SEGMENTS

MBIA provides innovative and cost-effective products and services that meet the credit enhancement, financial and investment needs of its public- and private-sector clients worldwide. MBIA manages its activities primarily through three principal business operations: insurance, investment management services and municipal services. The Company has defined reportable segments within its business operations based on the way management assesses the performance and resource requirements of such operations.

The insurance operations constitute a reportable segment and provide an unconditional and irrevocable guarantee of the payment of principal and interest on insured obligations when due. MBIA issues financial guarantees for municipal bonds, asset-backed and mortgage-backed securities, investor-owned utility bonds, bonds backed by publicly or privately funded public-purpose projects, bonds issued by sovereign and sub-sovereign entities, obligations collateralized by diverse pools of corporate loans and credit default swaps and pools of corporate and

asset-backed bonds, both in the new issue and secondary markets. This segment includes all activities related to global credit enhancement services provided principally by MBIA Corp. and its subsidiaries.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

MBIA Inc. and Subsidiaries

The Company s investment management services operations provide an array of products and services to the public, not-for-profit and corporate sectors. Such products and services are provided primarily through wholly owned subsidiaries of MBIA Asset Management, LLC (MBIA-AML) and include cash management, discretionary asset management and fund administration services and investment agreement, medium-term note and commercial paper programs related to funding assets for third-party clients and for investment purposes. The investment management services operations reportable segments are comprised of: asset/liability products, which include investment agreements and medium-term notes (MTNs) not related to the conduit program; advisory services, which consist of third-party and related-party fee-based asset management; and conduits. During the second quarter of 2004, the Company completed the sale of the assets of 1838, the Company s equity advisory services segment. This segment is reported as a discontinued operation. See Note 16 for further information related to the Company s discontinued operations.

The asset/liability products segment is principally comprised of the activities of MBIA Investment Management Corp. (IMC), MBIA Global Funding, LLC (GFL) and Euro Asset Acquisition Limited (EAAL). IMC, along with MBIA Inc., provides customized investment agreements, guaranteed by MBIA Corp., for bond proceeds and other public funds for such purposes as construction, loan origination, escrow and debt service or other reserve fund requirements. It also provides customized products for funds that are invested as part of asset-backed or structured product issuances. GFL raises funds through the issuance of MTNs with varying maturities, which are in turn guaranteed by MBIA Corp. GFL lends the proceeds of these MTN issuances to MBIA Inc. and EAAL (GFL Loans). MBIA Inc. and EAAL invest the proceeds of investment agreements and GFL Loans in eligible investments, which consist of investment grade securities with a minimum average Double-A credit quality rating. These investments are pledged to MBIA Corp. as security for its guarantees on investment agreements and MTNs. MBIA Inc. primarily purchases domestic assets and EAAL primarily purchases foreign assets as permitted under the Company s investment guidelines.

The advisory services segment is primarily comprised of the operations of MBIA Municipal Investors Service Corporation (MBIA-MISC) and MBIA Capital Management Corp. (CMC). MBIA-MISC provides investment management programs including pooled investments products and customized asset management services. In addition, MBIA-MISC provides portfolio accounting and reporting for state and local governments including school districts. MBIA-MISC is a SEC-registered investment adviser. CMC provides fee-based asset management services to the Company, its affiliates and third-party institutional clients. CMC is a SEC-registered investment advisor and National Association of Securities Dealers member firm.

The Company s conduit segment administers three multi-seller conduit financing vehicles, Triple-A, Meridian and Polaris through MBIA Asset Finance, LLC. The Conduits provide funding for multiple customers through special purpose vehicles that issue primarily commercial paper and medium-term notes.

The Company s municipal services operations constitute a reportable segment and provide revenue enhancement services and products to public-sector clients nationwide, consisting of discovery, audit, collections/recovery and information services through MBIA MuniServices Company and its wholly owned subsidiaries. Additionally, the municipal services operations include Capital Asset Holdings GP, Inc. and certain affiliated entities, a servicer of delinquent tax certificates.

The Company s corporate operations constitute a reportable segment and include investment income, interest expense and general expenses that relate to general corporate activities and not to one of the Company s three principal business operations.

Table of Contents

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

MBIA Inc. and Subsidiaries

Reportable segment results are presented net of material intersegment transactions. Transactions between the Company s segments are executed at an arm s length basis, as established by management. The following table summarizes the Company s operations for the years ended December 31, 2005, 2004 and 2003:

	Year ended December 31, 2005				
In thousands	**Insurance**	**Investment Management Services**	**Municipal Services**	**Corporate**	**Total**
Revenues[a]	$ 1,362,834	$ 866,154	$ 24,388	$ 16,646	$ 2,270,022
Net realized gains (losses)	(8,075)	1,384	(187)	(989)	(7,867)
Net gains (losses) on derivative instruments and foreign exchange	(4,436)	42,558	230		38,352
Total revenues	1,350,323	910,096	24,431	15,657	2,300,507
Interest expense		705,340		90,999	796,339
Operating expenses	294,229	74,194	22,316	97,481	488,220
Total expenses	294,229	779,534	22,316	188,480	1,284,559
Net income (loss) before taxes	$ 1,056,094	$ 130,562	$ 2,115	$ (172,823)	$ 1,015,948
Identifiable assets[b]	$ 13,075,561	$ 21,143,754	$ 25,770	$ 316,309	$ 34,561,394

	Year ended December 31, 2004				
In thousands	**Insurance**	**Investment Management Services**	**Municipal Services**	**Corporate**	**Total**
Revenues[a]	$ 1,365,624	$ 551,926	$ 27,593	$ 8,446	$ 1,953,589
Net realized gains (losses)	108,874	(4,120)	(81)	(467)	104,206
Net gains (losses) on derivative instruments and foreign exchange	6,627	(9,670)	(279)		(3,322)
Total revenues	1,481,125	538,136	27,233	7,979	2,054,473
Interest expense		413,615		74,651	488,266
Operating expenses	273,474	76,912	25,649	17,579	393,614
Total expenses	273,474	490,527	25,649	92,230	881,880
Net income (loss) before taxes	$ 1,207,651	$ 47,609	$ 1,584	$ (84,251)	$ 1,172,593
Identifiable assets[b]	$ 12,446,431	$ 20,146,474	$ 29,150	$ 414,240	$ 33,036,295

Table of Contents

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

MBIA Inc. and Subsidiaries

In thousands	Year ended December 31, 2003 Insurance	Investment Management Services	Municipal Services	Corporate	Total
Revenues[(a)]	$ 1,270,409	$ 403,990	$ 26,814	$ 9,000	$ 1,710,213
Net realized gains (losses)	48,157	17,135	139	15,237	80,668
Net gains (losses) on derivative instruments and foreign exchange	104,030	(8,995)			95,035
Total revenues	1,422,596	412,130	26,953	24,237	1,885,916
Interest expense		302,224		68,368	370,592
Operating expenses	256,189	55,005	25,857	14,874	351,925
Total expenses	256,189	357,229	25,857	83,242	722,517
Net income (loss) before taxes	$ 1,166,407	$ 54,901	$ 1,096	$ (59,005)	$ 1,163,399
Identifiable assets[(b)]	$ 13,127,763	$ 16,640,294	$ 26,445	$ 481,210	$ 30,275,712

(a) Represents the sum of net premiums earned, net investment income, advisory fees, investment management fees and other fees.

(b) At December 31, 2005 and 2004, there were no assets associated with the Company s discontinued operations. Identifiable assets relating to the Company s discontinued operations were $25.0 million at December 31, 2003.

The following table summarizes the segments within the investment management services operations for the years ended December 31, 2005, 2004 and 2003:

In thousands	Year ended December 31, 2005 Asset/ Liability Products	Advisory Services	Conduits	Eliminations	Total Investment Management Services
Revenues[(a)]	$ 622,722	$ 56,760	$ 203,323	$ (16,651)	$ 866,154
Net realized gains (losses)	1,383	1			1,384
Net gains (losses) on derivative instruments and foreign exchange	20,606	(16)	21,968		42,558
Total revenues	644,711	56,745	225,291	(16,651)	910,096
Interest expense	527,471	835	177,034		705,340
Operating expenses	38,753	36,315	15,632	(16,506)	74,194
Total expenses	566,224	37,150	192,666	(16,506)	779,534

Net income (loss) before taxes	$ 78,487	$ 19,595	$ 32,625	$ (145)	$ 130,562
Identifiable assets	$ 16,782,346	$ 62,633	$ 4,645,771	$ (346,996)	$ 21,143,754

95

Table of Contents

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

MBIA Inc. and Subsidiaries

	Year ended December 31, 2004				
In thousands	Asset/ Liability Products	Advisory Services	Conduits	Eliminations	Total Investment Management Services
Revenues[(a)]	$ 405,466	$ 51,013	$ 110,080	$ (14,633)	$ 551,926
Net realized gains (losses)	(3,750)	(370)			(4,120)
Net gains (losses) on derivative instruments and foreign exchange	(8,219)	(8)	(1,443)		(9,670)
Total revenues	393,497	50,635	108,637	(14,633)	538,136
Interest expense	329,790		83,825		413,615
Operating expenses	37,530	34,466	18,704	(13,788)	76,912
Total expenses	367,320	34,466	102,529	(13,788)	490,527
Net income (loss) before taxes	$ 26,177	$ 16,169	$ 6,108	$ (845)	$ 47,609
Identifiable assets	$ 13,428,870	$ 53,822	$ 7,024,024	$ (360,242)	$ 20,146,474

	Year ended December 31, 2003				
In thousands	Asset/ Liability Products	Advisory Services	Conduits	Eliminations	Total Investment Management Services
Revenues[(a)]	$ 354,386	$ 52,742	$ 21,134	$ (24,272)	$ 403,990
Net realized gains (losses)	17,135				17,135
Net gains (losses) on derivative instruments and foreign exchange	(9,673)		678		(8,995)
Total revenues	361,848	52,742	21,812	(24,272)	412,130
Interest expense	294,068		15,776	(7,620)	302,224
Operating expenses	29,010	35,473	4,984	(14,462)	55,005
Total expenses	323,078	35,473	20,760	(22,082)	357,229
Net income (loss) before taxes	$ 38,770	$ 17,269	$ 1,052	$ (2,190)	$ 54,901
Identifiable assets	$ 10,029,664	$ 29,170	$ 6,949,714	$ (368,254)	$ 16,640,294

(a) Represents the sum of interest income, investment management services fees and other fees.

An increasingly significant portion of premiums reported within the insurance segment is generated outside the U. S. The following table summarizes net premiums earned by geographic location of risk for years ended December 31, 2005, 2004 and 2003.

Table of Contents

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

MBIA Inc. and Subsidiaries

In millions	Years ended December 31 2005	2004	2003
Total premiums earned:			
United States	$ 620	$ 637	$ 615
Non-United States	223	213	158
Total	$ 843	$ 850	$ 773

NOTE 16: DISCONTINUED OPERATIONS

In May 2004, the Company completed the sale of the assets of 1838, a full service equity-focused asset management firm, to the management of 1838 together with an investor group led by Orca Bay Partners, which resulted in a $3.2 million after-tax gain. The sale of 1838 resulted from the Company s decision to exit the equity advisory market and focus on fixed-income asset management. 1838 comprised the equity advisory services segment of the Company s investment management services operations.

Income/(loss) from discontinued operations, net of tax, for the years ended December 31, 2005, 2004 and 2003 were a loss of $1.1 million, $0.6 million and income of $2.1 million, respectively. In 2005, expenses of $1.1 million, net of tax, were incurred to terminate an operating lease. The following table reports the amounts included in income/(loss) from discontinued operations before income taxes:

In thousands	Years ended December 31 2005	2004	2003
Revenues	$	$ 5,494	$ 18,665
Expenses	1,682	6,166	15,321
Income/(loss) before income taxes	$ (1,682)	$ (672)	$ 3,344

At December 31, 2005 and 2004, there were no assets associated with the Company s discontinued operations. Identifiable assets at December 31, 2003 were $25.0 million. The identifiable assets in 2003 primarily consisted of cash, goodwill, property and equipment and other miscellaneous assets.

NOTE 17: DIVIDENDS AND CAPITAL REQUIREMENTS

Under New York State insurance law, without prior approval of the superintendent of the state insurance department, financial guarantee insurance companies can pay dividends from earned surplus subject to retaining a minimum capital requirement. In MBIA Corp. s case, regular dividends in any twelve-month period cannot be greater than 10% of policyholders surplus as shown on MBIA Corp. s latest filed statutory financial statements. In 2005 and 2004, MBIA Corp. declared and paid regular dividends of $95 million and $372 million, respectively, to MBIA Inc.

In addition to its regular dividends, in the fourth quarter of 2004 MBIA Corp. declared and paid a special dividend of $375 million to MBIA Inc., which was approved by the NYSID. MBIA Corp. s capital position, relative to its insured exposure, had improved substantially over the past several years as a result of improved premium rates and a higher quality insured portfolio, exceeding both the capital required by New York State insurance law and the rating agencies for purposes of maintaining its Triple-A ratings. The proceeds have been used primarily for share repurchases, general liquidity and other corporate purposes.

NYSID and certain other statutory insurance regulatory authorities in and outside the U.S., and the agencies that rate the bonds insured by MBIA Corp. and its subsidiaries, have various requirements relating to the maintenance of certain minimum ratios of statutory capital and reserves to net insurance in force. MBIA Corp. and its subsidiaries were in compliance with these requirements as of December 31, 2005 and 2004.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

MBIA Inc. and Subsidiaries

NOTE 18: STOCK REPURCHASES

In August 1999, the Company announced that its board of directors had authorized the repurchase of 11.25 million shares of common stock of the Company, after adjusting for the 2001 stock split. The Company began the repurchase program in the fourth quarter of 1999. In July 2004, the Company completed the repurchase of all 11.25 million shares and received authorization from its board of directors to repurchase 1 million shares under a new repurchase program. On August 5, 2004, the Company s board of directors authorized the repurchase of an additional 14 million shares of common stock in connection with the new repurchase program.

During 2005, 2004 and 2003, the Company purchased 5.9 million, 5.8 million and 1.9 million shares of common stock at an aggregate cost of $341.5 million, $328.9 million and $79.9 million, respectively. As of December 31, 2005, the Company had repurchased a total of 21.3 million shares under these plans at an average price of $50.28 per share. The Company will only repurchase shares under this program when it is economically attractive and within rating agency constraints, including the Triple-A claims-paying ratings of MBIA Corp. Share repurchases increase the Company s treasury stock, which is carried at cost as a component of stockholders equity.

During 2005, 474,148 shares were purchased by the Company for settling awards under the Company s long-term incentive plans.

NOTE 19: SHORT-TERM DEBT, LONG-TERM DEBT AND OTHER BORROWING ARRANGEMENTS

The Company s short-term debt consists of floating rate certificates issued as part of Tender Option Bond (TOB) trades. A TOB trade is a repackaging of municipal bonds, effectively providing MBIA with leveraged securitized financing of long-term bonds at short-term tax-exempt rates. At December 31, 2005 and 2004, floating rate certificates related to the TOB trades included in short-term debt totaled $58.7 million. The aggregate weighted-average interest rate as of December 31, 2005 and 2004 was 3.55% and 1.43%, respectively. Assets supporting these certificates are included in the Company s available-for-sale fixed-maturity investment portfolio.

The Company s long-term debt consists of notes and debentures listed in the following table by maturity date:

In thousands	As of December 31 2005	2004
5.180% Notes due 2008*	$ 4,550	$ 5,550
7.560% Notes due 2010	132,782	153,900
9.375% Notes due 2011	100,000	100,000
6.400% Senior Notes due 2022**	299,391	299,411
7.000% Debentures due 2025	75,000	75,000
7.150% Debentures due 2027	100,000	100,000
6.625% Debentures due 2028	150,000	150,000
5.700% Senior Notes due 2034***	350,000	350,000
8.000% Public Income Notes due 2040****		100,000
	1,211,723	1,333,861
Less unamortized discount	1,767	1,861
Plus unamortized premium	449	540
Total	$ 1,210,405	$ 1,332,540

* Bears interest at three-month LIBOR plus a fixed spread. The interest rate in effect as of December 31, 2005 and 2004 was 5.180% and 3.170%, respectively.

** Callable 8/2006 at 100.00

*** Callable at any time at the greater of 100.00 or the present value of the remaining scheduled payments of principal and interest.

**** Called 12/2005 at 100.00

The Company s long-term debt is subject to certain covenants, none of which significantly restricts the Company s operating activities or dividend-paying ability.

98

Table of Contents

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

MBIA Inc. and Subsidiaries

In December 2005, the Company called and redeemed its $100 million outstanding 8% Public Income Notes Securities (PINES) due on December 15, 2040. The PINES were redeemed at a price equal to one hundred percent of the principal amount plus accrued and unpaid interest thereon to the date of redemption.

In November 2004, the Company completed a $350 million debt offering of 30-year senior notes, which carry a coupon rate of 5.7%. These notes are redeemable at the Company s option, in whole or in part, at any time prior to maturity. Part of the proceeds from this offering were used to redeem the Company s $50 million 6.95% Senior Quarterly Income Debt Securities (Senior QUIDS) due November 1, 2038, in December 2004. The Senior QUIDS were redeemed at a price equal to one hundred percent of the principal amount plus accrued and unpaid interest thereon to the date of redemption. The remainder of the proceeds were used to redeem the $100 million 8% PINES in December 2005 and for general corporate purposes.

In connection with the 7.56% Notes due 2010, MBIA entered into a swap transaction that met the criteria for cash flow hedge accounting. The swap transaction converts the interest rate from a fixed Swiss franc debt rate of 4.5% to a fixed U.S. dollar rate of 7.56% and converts the Swiss franc principal amount due at maturity to a fixed U.S. dollar amount of approximately $99.3 million.

The aggregate maturity of long-term debt obligations, excluding accrued interest and premiums or discounts, as of December 31, 2005 for each of the next five years and thereafter commencing in 2006 was:

In thousands	2006	2007	2008	2009	2010	After 2010	Total
Long-term debt obligations due	$	$	$ 4,550	$	$ 132,782	$ 1,074,391	$ 1,211,723

MBIA Corp. has a limited resource standby line of credit facility in the amount of $450 million, reduced from $700 million at December 31, 2004, with a group of major Triple-A rated banks to provide funds for the payment of claims in excess of the greater of $500 million of cumulative claims, net of recoveries, or 5% of average annual debt service with respect to public finance transactions. The agreement is for a ten-year term, amended from a seven-year term, which expires in March 2015.

MBIA Corp. has access to $400 million of Money Market Committed Preferred Custodial Trust securities (CPCT securities) issued by eight trusts, which were created for the primary purpose of issuing CPCT securities and investing the proceeds in high quality commercial paper or short-term U.S. Government obligations. MBIA Corp. has a put option to sell to the trusts the perpetual preferred stock of MBIA Corp. If MBIA Corp. exercises its put option, the trusts will transfer the proceeds to MBIA Corp. in exchange for the preferred stock. The trusts will hold the preferred stock and distribute the preferred dividend to their holders. MBIA Corp. has the right to redeem the preferred shares, and then put the preferred stock back to the trust again, indefinitely. Any preferred stock issued by MBIA Corp. would be non-cumulative unless MBIA Corp. pays dividends on its common stock, during which time the dividends on its preferred stock would be cumulative. Preferred stockholders would have rights that are subordinated to insurance claims, as well as to general unsecured creditors, but senior to any common stockholders of MBIA Corp.

The trusts are vehicles for providing capital support to MBIA Corp. by allowing it to obtain immediate access to new capital at its sole discretion at any time through the exercise of the put options. S&P and Moody s rate the trusts AA and Aa2, respectively. To date, MBIA Corp. has not exercised its put options under any of these arrangements.

As a part of MBIA s external borrowing capacity, it maintained two bank lines totaling $500 million as of December 31, 2004. These bank lines were maintained with a group of highly rated global banks and were comprised of a renewable $167 million facility with a term of 364 days and a $333 million facility with a five-year term maturing in April 2009. In April 2005, the $167 million facility expired on its stated expiration date and the $333 million facility was increased to $500 million and the term was extended one year to April 2010. The facility contains certain covenants including, among others, that the consolidated net worth of MBIA Inc. and MBIA Corp. will not fall below $2.8 billion and that the ratio of consolidated debt to equity for MBIA Inc. and MBIA Corp. will not exceed 30%, at any time. During 2005, there were no balances outstanding under the facility.

The Company has $19.8 million of outstanding letters of credit for MBIA-MISC that are intended to support the net asset value of certain investment pools managed by MBIA-MISC. These letters of credit can be drawn upon in the event that the liquidation of such assets is required and the proceeds are less than the cost. In addition, the Company has issued commitments to three pooled investment programs managed or administered by MBIA-MISC and its subsidiary. These commitments cover losses in such programs should the net asset values per share decline below specified per share values. At December 31, 2005, the maximum amount of future payments that the Company would be required to make under these commitments was $2.7 billion. These commitments shall be in effect so long as MBIA-MISC and its subsidiary remain as manager or administrator and each program remains in compliance with its respective investment objectives and policies.

Table of Contents

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

MBIA Inc. and Subsidiaries

NOTE 20: INVESTMENT AGREEMENT, COMMERCIAL PAPER AND MEDIUM-TERM NOTE OBLIGATIONS

Obligations under investment agreement contracts are recorded as liabilities on the Company s balance sheet based upon proceeds received plus unpaid accrued interest at the balance sheet date. Upon the occurrence of certain contractually agreed-upon events, some of these funds may be withdrawn prior to their expected withdrawal dates by the investor. Investment agreements have been issued with either fixed or floating interest rates. As of December 31, 2005, the annual interest rates on these agreements ranged from 0.61% to 7.93% and the weighted-average interest rate was 4.11%. As of December 31, 2004, the annual interest rates on these agreements ranged from 0.61% to 8.02% and the weighted-average interest rate was 3.49%. Principal payments due under these investment agreements in each of the next five years ending December 31 and thereafter, based upon expected withdrawal dates, are as follows:

In thousands	**Principal Amount***
Expected withdrawal date:	
2006	$ 2,886,507
2007	1,610,932
2008	676,024
2009	796,779
2010	1,353,809
Thereafter	4,109,998
Total	$ 11,434,049

* Foreign currency denominated investment agreements are presented in U.S. dollars. Amounts reflect principal due at maturity for investment agreements issued at a discount.

IMC also provides agreements obligating it to purchase designated securities in a bond reserve fund at par value upon the occurrence of certain contractually agreed-upon events. The opportunities and risks in these agreements are analogous to those of investment agreements. The total par value of securities subject to these agreements was $19.1 million at December 31, 2005.

Under private placement offerings, Triple-A issues commercial paper with maturities of up to 270 days. Outstanding commercial paper obligations, net of unamortized discount, at December 31, 2005 were $860 million and at December 31, 2004 were $2.6 billion. As of December 31, 2005, commercial paper outstanding had original issue maturities ranging from January 3, 2006 to March 22, 2006, interest rates ranging from 4.21% to 4.52% and a weighted-average interest rate of 4.35%. As of December 31, 2004, commercial paper outstanding had original issue maturities ranging from January 3, 2005 to March 30, 2005, interest rates ranging from 2.09% to 2.55% and a weighted-average interest rate of 2.34%. Triple-A enters into 364-day or shorter term credit facilities with multiple independent third-party credit support providers as a source of liquidity in the event of a commercial paper market disruption.

Medium-term note obligations are recorded as liabilities on the Company s balance sheet based upon proceeds received, net of unamortized discounts and premiums, plus unpaid accrued interest at the balance sheet date. Medium-term notes are issued by GFL as part of MBIA s asset/liability products and by Meridian, Triple-A and Polaris as part of MBIA s conduit program. In 2005, GFL issued 2.3 billion of U.S. dollar and 250.0 million of Euro-denominated medium-term notes. Medium-term notes have been issued with either fixed or floating interest rates. As of December 31, 2005, the annual interest rates of the medium-term notes ranged from 2.80% to 5.89% and the weighted-average interest rate was 5.24%. As of December 31, 2004, the annual interest rates of the medium-term notes ranged from 0.09% to 5.98% and the weighted-average interest rate was 3.09%. Principal payments due under medium-term note obligations based on their contractual maturity dates are as follows:

In thousands	Principal Amount*
Maturity date:	
2006	$ 2,124,406
2007	1,752,615
2008	744,801
2009	619,328
2010	452,044
Thereafter	2,899,616
Total	$ 8,592,810

* Foreign currency denominated medium-term notes are presented in U.S. dollars. Amounts reflect the principal due at maturity for notes issued at a discount or premium.

100

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

MBIA Inc. and Subsidiaries

NOTE 21: NET INSURANCE IN FORCE

MBIA Corp. guarantees the timely payment of principal and interest on municipal, asset-/mortgage-backed and other non-municipal securities. MBIA Corp. s ultimate exposure to credit loss in the event of nonperformance by the insured is represented by the net insurance in force in the tables that follow.

The insurance policies issued by MBIA Corp. are unconditional commitments to guarantee timely payment on insured obligations to holders of the insured obligations. The creditworthiness of each insured issue is evaluated prior to the issuance of insurance, and each insured issue must comply with MBIA Corp. s underwriting guidelines. Further, the payments to be made by the issuer on the bonds or notes may be backed by a pledge of revenues, reserve funds, letters of credit, investment contracts or collateral in the form of mortgages or other assets. The right to such funds or collateral would typically become MBIA Corp. s upon the payment of a claim by MBIA Corp.

MBIA Corp. maintains underwriting guidelines based on those aspects of credit quality that it deems important for each category of obligation considered for insurance. For global public finance transactions these include economic and social trends, debt and financial management, adequacy of anticipated cash flow, satisfactory legal structure and other security provisions, viable tax and economic bases, adequacy of loss coverage and project feasibility. For global structured finance transactions, MBIA Corp. s underwriting guidelines, analysis and due diligence focus on seller/servicer credit and operational quality. MBIA also analyzes the quality of asset pools, as well as their historical and projected performance. The strength of a structure, including legal segregation of the assets, cash flow analysis, the size and source of first loss protection, asset performance triggers and financial covenants are also reviewed. Such guidelines are subject to periodic review by management, which is responsible for establishing the criteria for the Company s underwriting standards as well as maintaining the standards in its insurance operations.

As of December 31, 2005, insurance in force, net of cessions to reinsurers and other reimbursement agreements, had an expected maturity range of 1-51 years. Other reimbursement agreements that have been netted from the Company s insurance in force as reported below relate to contracts under which the Company is entitled to reimbursement of losses on its insured portfolio but which do not qualify as reinsurance under GAAP. These agreements resulted in deductions of $11.2 billion and $14.1 billion for 2005 and 2004, respectively. The distribution of net insurance in force by geographic location, excluding $15.7 billion and $12.7 billion relating to transactions guaranteed by MBIA Corp. on behalf of various investment management services affiliated companies in 2005 and 2004, respectively, is set forth in the following table:

In billions	As of December 31			
	2005		2004	
Geographic Location	Net Insurance In Force	% of Net Insurance In Force	Net Insurance In Force	% of Net Insurance In Force
California	$ 115.4	13.0%	$ 113.6	12.9%
New York	64.5	7.3	65.1	7.3
Florida	42.8	4.8	40.5	4.5
Texas	36.2	4.1	35.4	4.0
Illinois	32.4	3.6	33.1	3.7
New Jersey	31.3	3.5	31.4	3.5
Massachusetts	23.6	2.6	23.2	2.6
Pennsylvania	22.7	2.6	23.4	2.6
Washington	20.9	2.4	20.6	2.3
Michigan	20.5	2.3	17.7	2.0
Subtotal	410.3	46.2	404.0	45.4
Nationally diversified	127.4	14.3	134.7	15.1

Other states	234.6	26.4	221.6	24.9
Total United States	772.3	86.9	760.3	85.4
Internationally diversified	49.5	5.5	57.6	6.5
Country specific	67.2	7.6	72.3	8.1
Total Non-United States	116.7	13.1	129.9	14.6
Total	$ 889.0	100.0%	$ 890.2	100.0%

Table of Contents

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

MBIA Inc. and Subsidiaries

The net insurance in force by type of bond is set forth in the following table:

In billions Bond Type	As of December 31 2005 Net Insurance In Force	% of Net Insurance In Force	2004 Net Insurance In Force	% of Net Insurance In Force
Global Public Finance:				
United States				
General obligation	$ 248.9	28.0%	$ 236.5	26.7%
Utilities	114.5	12.9	107.9	12.1
Special revenue	75.6	8.5	87.9	9.9
Transportation	58.1	6.5	55.4	6.2
Health care	52.4	5.9	58.0	6.5
Higher education	38.9	4.4	34.8	3.9
Housing	30.8	3.4	29.3	3.3
Investor-owned utilities	18.5	2.1	21.8	2.4
Total United States	637.7	71.7	631.6	71.0
Non-United States				
Sovereign	15.2	1.7	16.1	1.7
Transportation	13.9	1.6	14.8	1.6
Utilities	8.9	1.0	9.1	1.0
Investor-owned utilities	5.2	0.6	5.2	0.6
Sub-sovereign	1.0	0.1	1.4	0.2
Housing	0.5	0.1	0.5	0.1
Health care	0.4	0.0	0.6	0.1
Higher education	0.1	0.0	0.1	0.0
Total Non-United States	45.2	5.1	47.8	5.3
Total Global Public Finance	682.9	76.8	679.4	76.3
Global Structured Finance:				
United States				
Collateralized debt obligations	44.3	5.0	47.4	5.3
Asset-backed:				
Other	20.8	2.3	6.6	0.7
Auto	9.6	1.1	11.1	1.2
Credit cards	4.3	0.5	7.8	0.9
Leasing	0.4	0.0	0.8	0.1
Mortgage-backed:				
Home equity	19.2	2.2	17.9	2.0
Other	8.3	0.9	10.3	1.2
First mortgage	3.9	0.4	4.2	0.5

Pooled corp. obligations & other	22.2	2.5	21.1	2.4
Financial risk	1.6	0.2	1.5	0.2
Total United States	134.6	15.1	128.7	14.5
Non-United States				
Collateralized debt obligations	37.3	4.2	41.4	4.7
Mortgage-backed:				
First mortgage	13.1	1.5	13.2	1.5
Other	5.5	0.6	8.3	0.9
Home equity	0.7	0.1	1.2	0.1
Pooled corp. obligations & other	7.6	0.9	9.9	1.1
Asset-backed	5.0	0.6	5.6	0.6
Financial risk	2.3	0.2	2.5	0.3
Total Non-United States	71.5	8.1	82.1	9.2
Total Global Structured Finance	206.1	23.2	210.8	23.7
Total	$889.0	100.0%	$ 890.2	100.0%

102

Table of Contents

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

MBIA Inc. and Subsidiaries

The insurance operations have entered into certain guarantees of derivative contracts, included in the preceding tables, which do not qualify for the financial guarantee scope exception under SFAS 133. MBIA Corp. generally guarantees the timely payment of principal and interest related to these derivatives upon the occurrence of a credit event with respect to a referenced obligation. The maximum amount of future payments that MBIA Corp. may be required to make under these guarantees, should a full credit event occur, is $96.2 billion. This amount is net of cessions to reinsurance companies of $17.0 billion. MBIA Corp. s guarantees of derivative contracts have a legal maximum maturity range of 1-91 years. A small number of guaranteed credit derivative contracts have long maturities to satisfy regulatory requirements imposed on MBIA s counterparties. However, the expected maturities of such contracts are much shorter due to amortizations and prepayments in the underlying collateral pools. In accordance with SFAS 133, the fair values of these guarantees at December 31, 2005 are recorded on the balance sheet as assets and liabilities, representing gross gains and losses, of $40.3 million and $32.1 million, respectively. These derivative contracts are discussed further in Note 7.

MBIA Corp. may hold recourse provisions with third parties in derivative transactions through both reinsurance and subrogation rights. MBIA Corp. s reinsurance arrangements provide that should MBIA Corp. pay a claim under a guarantee of a derivative contract, then MBIA Corp. could collect amounts from any reinsurers that have reinsured the guarantee on either a proportional or non-proportional basis, depending upon the underlying reinsurance agreement. MBIA Corp. may also have recourse through subrogation rights whereby if MBIA Corp. makes a claim payment, it is entitled to any rights of the insured counterparty, including the right to any assets held as collateral.

MBIA Corp. has also issued guarantees of certain obligations issued by its investment management affiliates that are not included in the previous tables. These guarantees take the form of insurance policies issued by MBIA Corp. on behalf of the investment management affiliates. Should one of these affiliates default on its insured obligations, MBIA Corp. will be required to pay all scheduled principal and interest amounts outstanding. As of December 31, 2005, the maximum amount of future payments that MBIA Corp. could be required to make under these guarantees, should a full default occur, is $15.7 billion. These guarantees have a maximum maturity range of 1-59 years, were entered into on an arm s length basis and are fully collateralized by marketable securities. MBIA Corp. has both direct recourse provisions and subrogation rights in these transactions. If MBIA Corp. is required to make a payment under any of these affiliate guarantees, it would have the right to seek reimbursement from such affiliate and to liquidate any collateral to recover all or a portion of the amounts paid under the guarantee.

Table of Contents

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

MBIA Inc. and Subsidiaries

NOTE 22: REINSURANCE

MBIA Corp. reinsures exposure to other insurance companies under various treaty and facultative reinsurance contracts, both on a pro-rata and non-proportional basis. Additionally, the Company has entered into other reimbursement agreements under which it is entitled to reimbursement of losses on its insured portfolio but which do not qualify as reinsurance under GAAP. These reimbursement agreements totaled $11.2 billion and $14.1 billion at December 31, 2005 and 2004, respectively, and have been excluded from the tables below. In the event that any or all of the reinsurers are unable to meet their obligations, MBIA Corp. would be liable for such defaulted amounts.

Amounts deducted from gross insurance in force for reinsurance ceded by MBIA Corp. and its subsidiaries were $106.7 billion and $112.8 billion. The distribution of ceded insurance in force by geographic location is set forth in the following table:

In billions	As of December 31			
	2005		2004	
Geographic Location	Ceded Insurance In Force	% of Ceded Insurance In Force	Ceded Insurance In Force	% of Ceded Insurance In Force
California	$ 9.5	8.9%	$ 10.7	9.5%
New York	4.9	4.6	4.9	4.4
Texas	3.4	3.2	3.7	3.3
Massachusetts	3.3	3.1	3.3	2.9
Florida	3.2	3.0	3.5	3.1
Colorado	2.8	2.6	2.8	2.5
Puerto Rico	2.7	2.5	3.4	3.0
New Jersey	2.6	2.4	3.9	3.4
Illinois	2.1	2.0	2.3	2.0
Pennsylvania	1.6	1.5	1.8	1.6
Subtotal	36.1	33.8	40.3	35.7
Nationally diversified	18.8	17.5	18.9	16.7
Other states	17.0	16.0	17.3	15.4
Total United States	71.9	67.3	76.5	67.8
Internationally diversified	14.9	14.0	13.7	12.2
Country specific	19.9	18.7	22.6	20.0
Total Non-United States	34.8	32.7	36.3	32.2
Total	$ 106.7	100.0%	$ 112.8	100.0%

Table of Contents

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

MBIA Inc. and Subsidiaries

The distribution of ceded insurance in force, including other reimbursement agreements, by type of bond is set forth in the following table:

In billions	As of December 31			
	2005		2004	
Bond Type	**Ceded Insurance In Force**	**% of Ceded Insurance In Force**	**Ceded Insurance In Force**	**% of Ceded Insurance In Force**
Global Public Finance:				
United States				
General obligation	$ 13.3	12.4%	$ 14.0	12.4%
Transportation	9.9	9.3	11.0	9.8
Utilities	9.3	8.7	9.9	8.8
Health care	8.9	8.4	9.7	8.6
Special revenue	6.1	5.7	7.8	6.9
Higher education	1.8	1.7	1.7	1.5
Housing	1.6	1.5	1.7	1.5
Investor-owned utilities	1.6	1.5	2.6	2.3
Total United States	52.5	49.2	58.4	51.8
Non-United States				
Transportation	5.8	5.4	5.3	4.7
Sovereign	3.5	3.3	4.0	3.5
Utilities	3.4	3.2	3.7	3.3
Investor-owned utilities	1.5	1.4	1.7	1.5
Sub-sovereign	0.6	0.6	1.0	0.8
Health care and other	0.2	0.2	0.2	0.2
Total Non-United States	15.0	14.1	15.9	14.0
Total Global Public Finance	67.5	63.3	74.3	65.8
Global Structured Finance:				
United States				
Asset-backed:				
Auto	2.0	1.8	2.8	2.5
Other	1.6	1.5	0.5	0.4
Credit cards	1.0	1.0	1.7	1.5
Leasing	0.0	0.0	0.1	0.1
Collateralized debt obligations	6.1	5.7	5.2	4.6
Mortgage-backed:				
Home equity	2.3	2.1	3.2	2.8
Other	0.6	0.6	0.9	0.8
First mortgage	0.2	0.2	0.3	0.3

Pooled corp. obligations & other	5.5	5.2	3.3	2.9
Financial risk	0.1	0.0	0.1	0.1
Total United States	19.4	18.1	18.1	16.0
Non-United States				
Collateralized debt obligations	11.0	10.3	9.9	8.8
Mortgage-backed:				
First mortgage	1.7	1.6	1.8	1.6
Other	1.3	1.2	1.7	1.6
Home equity	0.2	0.2	0.3	0.3
Pooled corp. obligations & other	2.3	2.2	2.8	2.5
Financial risk	2.0	1.9	2.3	2.0
Asset-backed	1.3	1.2	1.6	1.4
Total Non-United States	19.8	18.6	20.4	18.2
Total Global Structured Finance	39.2	36.7	38.5	34.2
Total	$ 106.7	100.0%	$ 112.8	100.0%

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

MBIA Inc. and Subsidiaries

Reinsurance enables the Company to cede exposure for purposes of increasing its capacity to write new business while complying with its single risk and credit guidelines. The rating agencies continuously review reinsurers providing coverage to the financial guarantee industry. When a reinsurer is downgraded, less capital credit is given to a financial guarantee provider under rating agency models. Over the past several years, many of MBIA s reinsurers have been downgraded and others remain under review. Any reduced capital credit associated with reinsurer downgrades has not and is not expected to have a material adverse effect on the Company. The Company generally retains the right to reassume the business ceded to reinsurers under certain circumstances, including rating downgrades of its reinsurers. Additionally, MBIA requires certain reinsurers to maintain bank letters of credit or establish trust accounts to cover liabilities ceded to such reinsurers under reinsurance contracts. As of December 31, 2005, the total amount available under these letters of credit and trust arrangements was $593.5 million. For the years ended December 31, 2005, 2004 and 2003, recoveries received under reinsurance contracts totaled $5.8 million, $17.7 million and $6.4 million, respectively. The following table shows the percentage ceded to and reinsurance recoverable from reinsurers by rating levels:

Reinsurers	Standard & Poor s Rating	Moody s Rating	Percentage of Total Par Ceded	Reinsurance Recoverable (in thousands)
Channel Reinsurance Ltd.	AAA	Aaa	45.19%	$ 4,546
Assured Guaranty Corp.	AAA	Aa1	17.73	23,947
Ram Reinsurance Company, Ltd.	AAA	Aa3	12.20	4,386
Ambac Assurance Corporation	AAA	Aaa	9.40	
Mitsui Sumitomo Insurance Company Ltd.	AA-	Aa3	6.36	2
Swiss Reinsurance Company, Zurich, Switzerland	AA	Aa2	2.81	
Radian Asset Assurance Inc.	AA	Aa3	1.61	7,838
Assured Guaranty Re Ltd.	AA	Aa2	0.82	
Sompo Japan Insurance Inc.	AA-	Aa3	0.81	2
Transatlantic Reinsurance Company	AA-	Aa3	0.59	1,620
Other [(1)]	A or above	A1 or above	2.40	16,347
Not Currently Rated			0.08	277
Total			100.00%	$ 58,965

(1) Several reinsurers within this category are not rated by Moody s.

106

Table of Contents

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

MBIA Inc. and Subsidiaries

While Channel Re continues to be a Triple-A rated reinsurer of MBIA, S&P has revised their outlook on Channel Re from stable to negative in 2005. Additionally, MBIA owned an equity interest of 17.4% and 11.4% in Channel Re and RAM Holdings Ltd., the holding company of Ram Reinsurance Company, Ltd., respectively, at December 31, 2005.

In February 2004, MBIA Corp. and Channel Re entered into treaty and facultative reinsurance arrangements whereby Channel Re agreed to provide committed reinsurance capacity to MBIA Corp. through June 30, 2008 and subject to renewal thereafter. Under these reinsurance arrangements, MBIA Corp. agreed to cede to Channel Re and Channel Re agreed to assume from MBIA Corp. varying percentages of designated policies issued by MBIA Corp. The amount of any policy subject to the committed reinsurance arrangements is based on the type of risk insured and on other factors. Additionally, the reinsurance arrangements provide Channel Re with certain preferential terms, including those related to ceding commissions.

The components of net premiums written and earned, including premiums assumed from and ceded to other companies, are set forth in the following table:

	Years ended December 31					
	2005		2004		2003	
In thousands	**Written**	**Earned**	**Written**	**Earned**	**Written**	**Earned**
Direct	$ 972,017	$ 974,608	$ 1,100,234	$ 971,427	$ 1,249,832	$ 933,448
Assumed	12,891	19,235	16,681	24,780	18,976	32,193
Gross	984,908	993,843	1,116,915	996,207	1,268,808	965,641
Ceded	(127,107)	(151,101)	(158,831)	(146,537)	(193,889)	(192,647)
Net	$ 857,801	$ 842,742	$ 958,084	$ 849,670	$ 1,074,919	$ 772,994

Ceding commissions received from reinsurers, before deferrals and net of return ceding commissions, were $35.9 million, $37.2 million and $54.9 million in 2005, 2004 and 2003, respectively.

NOTE 23: LOSS AND LOSS ADJUSTMENT EXPENSE RESERVES

Loss and LAE reserves are established in an amount equal to the Company s estimate of unallocated losses, identified or case basis reserves and costs of settlement and other loss mitigation expenses on obligations it has insured. See Note 3 for additional information regarding the Company s loss reserving policy.

107

Table of Contents

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

MBIA Inc. and Subsidiaries

A summary of the unallocated and case basis activity and the components of the liability for loss and LAE reserves are shown in the following table:

In thousands	2005	2004	2003
Case basis loss and LAE reserves:			
Balance at January 1	$ 434,924	$ 387,253	$ 330,960
Less: reinsurance recoverable	34,610	61,402	43,815
Net balance at January 1	400,314	325,851	287,145
Case basis transfers from unallocated loss reserve related to:			
Current year	104,341	67,976	13,634
Prior years	84,264	58,849	46,175
Total	188,605	126,825	59,809
Net paid (recovered) related to:			
Current year	(2,949)	2,836	8,859
Prior years	137,945	49,526	12,244
Total net paid	134,996	52,362	21,103
Net balance at December 31	453,923	400,314	325,851
Plus: reinsurance recoverable	58,965	34,610	61,402
Case basis loss and LAE reserve balance at December 31	512,888	434,924	387,253
Unallocated loss reserve:			
Balance at January 1	313,945	324,578	307,273
Losses and LAE incurred	84,274	84,753	77,114
Channel Re elimination[1]	(1,000)	(624)	
Reserves related to ASIA Ltd.[2]		32,063	
Transfers to case basis and LAE reserves	(188,605)	(126,825)	(59,809)
Unallocated loss reserve balance at December 31	208,614	313,945	324,578
Total	$ 721,502	$ 748,869	$ 711,831

(1) Represents the amount of losses and LAE incurred that have been eliminated in proportion to MBIA s ownership interest in Channel Re, which is carried on an equity method accounting basis.

(2) Represents reserves associated with the assumption of portfolios from ASIA Ltd.

Unallocated loss reserves approximated $209 million at December 31, 2005, which represent the Company s estimate of losses associated with credit deterioration that has occurred in the Company s insured portfolio and are available for future case-specific activity. The Company

incurred $84 million of loss and loss adjustment expenses in 2005 based on 12% of scheduled earned premium. Additionally, the Company had salvage and subrogation of $143 million and $154 million as of December 31, 2005 and 2004, respectively, included in Other assets.

Table of Contents

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

MBIA Inc. and Subsidiaries

NOTE 24: PENSION AND PROFIT-SHARING PLANS

The Company has a non-contributory, defined contribution pension plan to which the Company contributes 10% of each eligible employee s annual compensation. Annual compensation consists of base salary, bonus and commissions, as applicable, for determining such contributions. Pension benefits vest over a five-year period with 60% vesting after three years and 20% in years four and five. Pension expense for the years ended December 31, 2005, 2004 and 2003 was $9.5 million, $9.7 million and $10.1 million, respectively.

The Company also has a profit-sharing/401(k) plan. The plan is a voluntary contributory plan that allows eligible employees to defer compensation for federal income tax purposes under Section 401(k) of the Internal Revenue Code of 1986, as amended. Employees may contribute through payroll deductions up to 10% of eligible compensation. The Company matches employee contributions up to the first 5% of such compensation with MBIA Inc. common stock. The benefit of the Company s contributions vests over five years with 60% vesting after three years and 20% in years four and five. Generally, a participating employee is entitled to distributions from the plan upon termination of employment, retirement, death or disability. Participants who qualify for distribution may receive a single lump sum, transfer the assets to another qualified plan or individual retirement account, or receive a series of specified installment payments. Company contributions to the profit-sharing/401(k) plan aggregated $4.5 million, $5.3 million and $5.1 million for the years ended December 31, 2005, 2004 and 2003, respectively.

Amounts relating to the above plans that exceed limitations established by federal regulations are contributed to a non-qualified deferred compensation plan. These non-qualified contributions are included in the above stated pension and profit-sharing/401(k) match amounts and totaled $2.7 million, $2.9 million and $3.4 million for the pension plan, and $1.5 million, $1.6 million and $1.7 million for the profit-sharing/401(k) plan for the years ending December 31, 2005, 2004 and 2003, respectively. In addition, the interest credited to the non-qualified deferred compensation plan totaled $2.6 million, $2.9 million and $2.2 million for the years ending December 31, 2005, 2004 and 2003, respectively.

NOTE 25: LONG-TERM INCENTIVE PLANS

On May 5, 2005, the Company s shareholders approved the MBIA Inc. 2005 Omnibus Incentive Plan (the Omnibus plan). Under the Omnibus plan, a maximum of 6,000,000 shares of the Company s common stock can be used for any type of award including stock options, performance shares, performance units, restricted stock, restricted stock units and dividend equivalents. Any shares issued under the Omnibus plan in connection with stock options shall be counted against this limit as one share covered by such option. For all awards other than stock options, any shares issued shall be counted against this limit as two shares for every share issued.

The stock option component of the Omnibus plan enables key employees of the Company and its subsidiaries to acquire shares of common stock of the Company or to benefit from appreciation in the price of the common stock of the Company. The stock option grants, which may be awarded every year, provide the right to purchase shares of common stock at the fair value of the stock on the date of the grant. Options granted will either be Incentive Stock Options (ISOs), where they qualify under Section 422(a) of the Internal Revenue Code, or Non-Qualified Stock Options (NQSOs). ISOs and NQSOs are granted at a price not less than 100% of the fair value, defined as the closing price on the grant date, of the Company s common stock. Options are exercisable as specified at the time of grant depending on the level of the recipient (generally four or five years) and expire ten years from the date of grant (or shorter if specified or following termination of employment).

Under the restricted stock component of the Omnibus plan, certain employees are granted restricted shares of the Company s common stock. These awards have a restriction period lasting three, four or five years depending on the type of award, after which time the awards fully vest. During the vesting period these shares may not be sold. Restricted stock grants are typically granted from the vice president level up to and including the chief executive officer. Some of the awards made in 2005 are linked to the growth in book value per share of the Company s common stock including certain adjustments (modified book value) over a three-year period following the grant date. Actual shares issued at the vesting date will be determined based on the growth in modified book value. If modified book value grows by 30% or more over the three year period then 100% of the award will vest. If the growth in modified book value over the three year period is lower than 30%, then the amount of restricted shares issued will be adjusted downward in proportion to the amount by which actual growth in modified book value is below 30%.

Table of Contents

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

MBIA Inc. and Subsidiaries

Following the effective date of the Omnibus plan, no new options or awards were granted under any of the prior plans authorized by the shareholders and all shares authorized but unissued were canceled. All options and awards granted under the prior plans and subsequently canceled or expired after the effective date of the Omnibus plan become available for grant under the Omnibus plan. In 2005, 66,000 options were granted and 98,401 options were canceled or expired. In 2005, 50,421 restricted shares were granted and 51,100 restricted shares were canceled. This restricted share activity affects the available share balance for future grants in the Omnibus plan at a two for one ratio. Therefore, 6,033,759 shares are available for future grants under the Omnibus plan as of December 31, 2005. In addition, during 2005 prior to the adoption of the Omnibus plan, 750,000 options were granted from the Company s 2000 Stock Option Plan and 466,355 restricted shares (net of cancellations) were granted from the Company s 2002 Restricted Stock Program.

In 2005 and 2004, under all plans in effect, a total of 465,676 and 603,267, respectively, restricted shares (net of cancellations) of the Company s common stock were granted to employees and directors of the Company. The fair value of the shares awarded (net of cancellations) in 2005 and 2004, determined on the grant date, was $27.2 million and $36.6 million, respectively. Restricted shares have been recorded as a separate component of shareholders equity as Unearned compensation-restricted stock on the Company s Consolidated Balance Sheets and have been included in Stock-based compensation on the Company s Consolidated Statements of Changes in Shareholders Equity. Unearned compensation is amortized to expense over the appropriate three- to five-year vesting period (except for a minor portion granted to members of the MBIA Inc. board of directors which is amortized over a ten-year period). Compensation expense related to the restricted stock was $18.5 million, $12.1 million and $6.3 million for the years ended December 31, 2005, 2004 and 2003, respectively.

In December 1995, the MBIA Inc. board of directors approved the MBIA Long-Term Incentive Program (the incentive program). The incentive program has been superceded by the Omnibus plan. The incentive program included a stock option component and a compensation component linked to the growth in modified book value over a three-year period following the grant date. Target levels for the incentive program awards were established as a percentage of total salary and bonus, based upon the recipient s position. Awards under the incentive program typically were granted from the vice president level up to and including the chief executive officer. Actual amounts to be paid are adjusted upward or downward depending on the growth of modified book value versus a baseline target, with a minimum growth of 8% necessary to receive any payment and an 18% growth necessary to receive the maximum payment. Awards under the incentive program were divided equally between the two components, with approximately 50% of the award to be given in stock options and approximately 50% of the award to be paid in cash or shares of Company stock. Payments are made at the end of each three-year measurement period. During 2005, 2004 and 2003, $8.5 million, $25.1 million and $21.8 million, respectively, were recorded as an expense related to modified book value awards.

Effective January 1, 2002 the Company adopted the fair value recognition provisions of SFAS 123 and the modified prospective method of adoption under SFAS 148. Under the modified prospective method of adoption selected by the Company under the provisions of SFAS 148, employee stock option compensation expense for the years ended December 31, 2005, 2004 and 2003 totaled $18.6 million, $16.7 million and $26.4 million, respectively.

Table of Contents

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

MBIA Inc. and Subsidiaries

The fair value for these options was estimated at the date of grant using the Black-Scholes option pricing model. The number of significant options granted and the assumptions used for valuing such option grants during the last three years are shown in the following table:

	February 2005	February 2004	February 2003
Number of options granted	750,000	745,200	1,414,010
Exercise price	$ 58.84	$ 64.84	$ 36.69
Dividend yield	2.357%	1.766%	2.180%
Expected volatility	.3311	.3384	.3330
Risk-free interest rate	4.010%	3.700%	3.483%
Expected option term (in years)	6.55	7.20	6.40

The Black-Scholes option valuation model was developed for use in estimating the fair value of traded options that have no vesting restrictions and are fully transferable. In addition, option valuation models require the input of highly subjective assumptions including the expected stock price volatility.

The following table displays the total number of options granted during the last three years. The proxy officers represent the five most highly compensated officers in 2005 and 2003. 2004 represents the seven most highly compensated officers disclosed in the Company s proxy statement.

	Number of Options Granted		
	2005	2004	2003
Proxy officers	360,000	352,000	669,000
Other senior officers	262,000	355,000	262,500
Senior officers	622,000	707,000	931,500
Other employees	194,000	350,515	504,510
Total	816,000	1,057,515	1,436,010

A summary of the Company s stock option plan as of December 31, 2005, 2004 and 2003, and changes during the years ending on those dates, is set forth in the following table:

	2005	
Options	Number of Shares	Weighted-Avg. Price per Share
Outstanding at beginning of year	9,497,018	$ 45.4433
Granted	816,000	58.9362
Exercised	528,316	59.4000
Expired or canceled	85,144	53.8047

Outstanding at year-end	9,699,558	$	46.7513
Exercisable at year-end	5,321,616	$	43.3642
Weighted-average fair value per share of options granted during the year		$	18.3649

Table of Contents

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

MBIA Inc. and Subsidiaries

Options	2004 Number of Shares	Weighted-Avg. Price per Share
Outstanding at beginning of year	10,123,348	$ 42.7479
Granted	1,057,515	62.8713
Exercised	1,453,409	63.3124
Expired or canceled	230,436	46.0938
Outstanding at year-end	9,497,018	$ 45.4433
Exercisable at year-end	5,140,182	$ 42.8981
Weighted-average fair value per share of options granted during the year		$ 21.5659

Options	2003 Number of Shares	Weighted-Avg. Price per Share
Outstanding at beginning of year	9,533,766	$ 42.1900
Granted	1,436,010	36.8754
Exercised	748,484	52.5683
Expired or canceled	97,944	45.1221
Outstanding at year-end	10,123,348	$ 42.7479
Exercisable at year-end	2,976,626	$ 39.3808
Weighted-average fair value per share of options granted during the year		$ 11.3446

The following table summarizes information about the plan s stock options at December 31, 2005:

Range of Average Exercise Price	Number Outstanding at 12/31/05	Weighted-Average Remaining Contractual Life in Years	Outstanding Weighted-Average Exercise Price	Number Exercisable at 12/31/05	Exercisable Weighted-Average Exercise Price
$25.92-32.92	906,407	3.78	$ 32.37	906,407	$ 32.37
$33.96-36.69	1,271,232	6.22	$ 36.56	369,878	$ 36.23
$36.72-47.95	3,903,496	3.53	$ 44.39	3,091,621	$ 44.87
$48.35-64.86	3,618,423	6.89	$ 56.48	953,710	$ 51.69
Total	9,699,558	5.16	$ 46.75	5,321,616	$ 43.36

Table of Contents

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

MBIA Inc. and Subsidiaries

NOTE 26: RELATED PARTY TRANSACTIONS

Related parties are defined as the following:

Affiliates of the Company: An affiliate is a party that directly or indirectly controls, is controlled by or is under common control with the Company. Control is defined as having, either directly or indirectly, the power to direct the management and policies of the Company through ownership, by contract or otherwise.

Entities for which investments are accounted for using the equity method by the Company.

Trusts for the benefit of employees, such as pension and profit-sharing trusts, that are managed by or under the trusteeship of management.

Principal owners of the Company defined as owners of record or known beneficial owners of more than 10 percent of the voting interests of the Company.

Management of the Company which includes persons who are responsible for achieving the objectives of the Company and who have the authority to establish policies and make decisions by which those objectives are to be pursued. Management normally includes members of the board of directors, the chief executive officer, chief operating officer, vice president in charge of principal business functions and other persons who perform similar policymaking functions.

Members of the immediate families of principal owners of the Company and its management. This includes family members whom a principal owner or a member of management might control or influence or by whom they may be controlled or influenced because of the family relationship.

Other parties with which the Company may deal if one party controls or can significantly influence the management or policies of the other to an extent that one of the transacting parties might be prevented from fully pursuing its own separate interests.

Other parties that can significantly influence the management or policies of the transacting parties or that have an ownership interest in one of the transacting parties and can significantly influence the other to the extent that one or more of the transacting parties might be prevented from fully pursuing its own separate interests.

From time to time the Company may enter into transactions with related parties that the Company deems immaterial or which occur in the normal course of business and are deemed to be transacted at arm s length by management. Since 1989, MBIA Corp. has executed five surety bonds to guarantee the payment obligations of the members of the Municipal Bond Insurance Association (the Association), a voluntary unincorporated association of insurers writing municipal bond and note insurance as agent for the member insurance companies that had their S&P claims-paying rating downgraded from Triple-A on their previously issued Association policies. In the event that they do not meet their Association policy payment obligations, MBIA Corp. will pay the required amounts directly to the paying agent. The aggregate outstanding exposure on these surety bonds as of December 31, 2005 is $340 million.

MBIA Inc., through its subsidiaries, is responsible for providing investment advisory and certain related administrative services to the MBIA Capital/Claymore Managed Duration Investment Grade Municipal Fund and, prior to the sale of 1838, provided such services to the 1838 Bond-Debenture Trading Fund and the 1838 Investment Advisors Funds (collectively, the Funds). Additionally, MBIA, Inc., through its subsidiaries, earned investment management, accounting, administration and service fees related to the Funds, which aggregated $0.7 million, $0.9 million and $1.4 million for the years ended December 31, 2005, 2004 and 2003, respectively, and are included in investment management services revenues in the Company s income statement.

The Company owns investments, included in other investments, which are recorded in the Company s financial statements using the equity method of accounting. These investments are comprised of equity interests in limited partnerships and in Channel Re. All material transactions between MBIA and these entities have been eliminated in MBIA s consolidated financial statements. During 2005, premiums ceded to Channel Re totaled $61.4 million and ceding commissions received from Channel Re totaled $14.2 million. Note 22 provides information with respect to the terms of the reinsurance arrangements between MBIA Corp. and Channel Re.

MBIA Corp. insures municipal bonds held by certain Guaranteed Series of Empire State Municipal Exempt Trusts. One of the co-sponsors of these trusts is Lebenthal & Co., Inc., whose chairman emeritus is James A. Lebenthal. Mr. Lebenthal served as a director of MBIA during 2004. The Company believes that the terms of these insurance policies and premiums charged are no less favorable than those related to similar unit investment trusts.

The Company had no loans outstanding to any executive officers or directors during 2005.

Table of Contents

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

MBIA Inc. and Subsidiaries

NOTE 27: FAIR VALUE OF FINANCIAL INSTRUMENTS

The estimated fair value amounts of financial instruments shown in the following table have been determined by the Company using available market information and widely accepted valuation methodologies. However, in certain cases considerable judgment was required to interpret market data in order to develop estimates of fair value. Accordingly, the estimates presented herein are not necessarily indicative of the amount the Company could realize in a current market exchange. The use of different market assumptions and/or estimation methodologies may have a material effect on the estimated fair value amounts.

FIXED-MATURITY SECURITIES The fair value of available-for-sale fixed-maturity securities, including securities pledged as collateral, is based upon quoted market prices, if available. If a quoted market price is not available, fair value is estimated using quoted market prices for similar securities.

INVESTMENTS HELD-TO-MATURITY The held-to-maturity investments are comprised of fixed and floating rate fixed-maturity securities. The fair value of the fixed rate investments is determined by calculating the net present value of estimated future cash flows assuming prepayments, defaults and discount rates that the Company believes market participants would use for similar assets. The carrying value of the floating rate investments approximates their fair value.

SHORT-TERM INVESTMENTS Short-term investments are carried at amortized cost, which approximates fair value.

OTHER INVESTMENTS Other investments include the Company s interest in equity-oriented and equity method investments. The fair value of these investments is based on quoted market prices, investee financial statements or cash flow modeling.

CASH AND CASH EQUIVALENTS, ACCRUED INVESTMENT INCOME, REINSURANCE RECOVERABLE ON UNPAID LOSSES, RECEIVABLE FOR INVESTMENTS SOLD, SHORT-TERM DEBT AND PAYABLE FOR INVESTMENTS PURCHASED The carrying amounts of these items are reasonable estimates of their fair values as they are short-term in nature.

PREPAID REINSURANCE PREMIUMS The fair value of the Company s prepaid reinsurance premiums is based on the estimated cost of entering into an assumption of the entire portfolio with third-party reinsurers under current market conditions.

DEFERRED PREMIUM REVENUE The fair value of the Company s deferred premium revenue is based on the estimated cost of entering into a cession of the entire portfolio with third-party reinsurers under current market conditions.

LOSS AND LOSS ADJUSTMENT EXPENSE RESERVES The carrying amount is composed of the present value of the expected cash flows for specifically identified claims combined with an estimate for unidentified claims. Therefore, the carrying amount is a reasonable estimate of the fair value of the reserve.

INVESTMENT AGREEMENTS AND MEDIUM-TERM NOTES The fair values of investment agreements and medium-term notes are estimated using discounted cash flow calculations based upon interest rates currently being offered for similar agreements and notes with maturities consistent with those remaining for the agreements and notes being valued.

COMMERCIAL PAPER The carrying value of commercial paper approximates its fair value primarily due to their short-term nature or variability in interest rates.

VARIABLE INTEREST ENTITY FLOATING RATE NOTES Variable interest entity floating rate notes consist of floating rate securities and related accrued interest. The carrying values of variable interest entity notes approximate their fair values due to the term of the applicable interest rates.

SECURITIES SOLD UNDER AGREEMENTS TO REPURCHASE The fair value is estimated using discounted cash flow calculations based upon interest rates currently being offered for similar agreements.

LONG-TERM DEBT The fair value is estimated based on quoted market prices for the same or similar securities.

DERIVATIVES The fair value is derived from market information and appropriate valuation methodologies which reflect the estimated amounts that the Company would receive or pay to terminate the transaction at the reporting date.

Table of Contents

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

MBIA Inc. and Subsidiaries

	As of December 31, 2005		As of December 31, 2004	
In thousands	Carrying Amount	Estimated Fair Value	Carrying Amount	Estimated Fair Value
ASSETS:				
Fixed-maturity securities	$ 24,476,275	$ 24,476,275	$ 20,410,775	$ 20,410,775
Investments held-to-maturity	5,765,182	5,734,335	7,540,218	7,535,787
Short-term investments	1,678,281	1,678,281	2,405,192	2,405,192
Other investments	234,927	234,927	261,865	261,865
Cash and cash equivalents	233,046	233,046	366,236	366,236
Accrued investment income	396,048	396,048	312,208	312,208
Prepaid reinsurance premiums	407,614	405,034	434,968	407,481
Reinsurance recoverable on unpaid losses	58,965	58,965	34,610	34,610
Receivable for investments sold	74,787	74,787	67,205	67,205
Derivative assets	326,867	326,867	288,564	288,564
LIABILITIES:				
Deferred premium revenue	$ 3,185,200	$ 3,100,263	$ 3,211,181	$ 3,005,482
Loss and loss adjustment expense reserves	721,502	721,502	748,869	748,869
Investment agreements	10,806,277	10,996,041	8,678,768	9,162,017
Commercial paper	859,997	859,997	2,598,655	2,598,655
Medium-term notes	7,542,416	7,554,408	6,943,840	6,930,925
Variable interest entity floating rate notes	1,280,160	1,280,160	600,505	600,505
Securities sold under agreements to repurchase	646,343	644,605	647,104	645,683
Short-term debt	58,745	58,745	58,745	58,745
Long-term debt	1,210,405	1,251,507	1,332,540	1,345,860
Payable for investments purchased	83,369	83,369	94,609	94,609
Derivative liabilities	384,611	384,611	527,455	527,455

Table of Contents

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

MBIA Inc. and Subsidiaries

NOTE 28: QUARTERLY FINANCIAL INFORMATION (Unaudited)

A summary of selected quarterly income statement information follows:

	2005				
	Restated	Restated			
In thousands except per share amounts	**First**	**Second**	**Third**	**Fourth**	**Full Year**
Gross premiums written	$ 282,619	$ 248,965	$ 220,970	$ 232,354	$ 984,908
Net premiums written	250,493	217,343	186,362	203,603	857,801
Premiums earned	210,845	213,385	204,072	214,440	842,742
Investment income and realized gains and losses	128,785	126,377	119,779	125,695	500,636
All other revenues	219,675	192,768	284,967	259,719	957,129
Income from continuing operations	212,807	173,674	142,877	182,721	712,079
Income from discontinued operations, net of tax	0	0	(1,093)	0	(1,093)
Net income	$ 212,807	$ 173,674	$ 141,784	$ 182,721	$ 710,986
Basic EPS:*					
Income from continuing operations	$ 1.55	$ 1.30	$ 1.08	$ 1.38	$ 5.31
Income from discontinued operations	0.00	0.00	(0.01)	0.00	(0.01)
Net income	$ 1.55	$ 1.30	$ 1.07	$ 1.38	$ 5.30
Diluted EPS:*					
Income from continuing operations	$ 1.52	$ 1.27	$ 1.05	$ 1.34	$ 5.19
Income from discontinued operations	0.00	0.00	(0.01)	0.00	(0.01)
Net income	$ 1.52	$ 1.27	$ 1.04	$ 1.34	$ 5.18

	2004				
In thousands except per share amounts	**First**	**Second**	**Third**	**Fourth**	**Full Year**
Gross premiums written	$ 204,693	$ 372,909	$ 255,609	$ 283,704	$ 1,116,915
Net premiums written	180,000	332,551	213,320	232,213	958,084
Premiums earned	209,094	219,154	210,994	210,428	849,670
Investment income and realized gains and losses	168,212	132,729	119,601	166,525	587,067
All other revenues	123,955	159,748	144,297	189,736	617,736
Income from continuing operations	212,160	218,230	183,211	226,869	840,470
Income from discontinued operations, net of tax	29	2,668	0	(121)	2,576
Net income	$ 212,189	$ 220,898	$ 183,211	$ 226,748	$ 843,046
Basic EPS:*					
Income from continuing operations	$ 1.48	$ 1.52	$ 1.30	$ 1.63	$ 5.92
Income from discontinued operations	0.00	0.02	0.00	0.00	0.02
Net income	$ 1.48	$ 1.54	$ 1.30	$ 1.63	$ 5.94
Diluted EPS:*					
Income from continuing operations	$ 1.45	$ 1.49	$ 1.27	$ 1.60	$ 5.80
Income from discontinued operations	0.00	0.02	0.00	0.00	0.02

Net income	$	1.45	$	1.51	$	1.27	$	1.60	$	5.82

* Due to rounding, quarterly per share amounts may not add to the totals for the years.

Table of Contents

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

MBIA Inc. and Subsidiaries

NOTE 29: CONTINGENCIES

In July 2002, MBIA Corp. filed suit against Royal Indemnity Company (Royal), in the United States District Court for the District of Delaware, to enforce insurance policies that Royal issued on certain vocational student loan transactions that MBIA Corp. insured. To date, claims in the amount of approximately $352 million have been made under the Royal policies with respect to loans that have defaulted. MBIA Corp. expects that there will be additional claims made under the policies with respect to student loans that may default in the future. Royal has filed an action seeking a declaration that it is not obligated to pay on its policies. If Royal does not honor its policies, MBIA Corp. will be required to make payment on the notes it insured, and will incur material losses under its policies. In October 2003, the court granted MBIA Corp. s motion for summary judgment and ordered Royal to pay all claims under its policies. Royal appealed the order, and pledged $389 million of investment grade collateral to MBIA Corp. to secure the entire amount of the judgment, with interest, and has agreed to post additional security for future claims and interest. The Federal District Court has ordered Royal to comply with the pledge agreement.

On October 3, 2005, the Court of Appeals for the Third Circuit upheld the decision of the United States District Court for the District of Delaware enforcing the Royal insurance policies and remanded the case to the District Court for a determination of whether the Royal policies cover all losses claimed under the policies. In particular, the Court of Appeals directed the District Court to consider whether the Royal policies cover losses resulting from the misappropriation rather than from defaults by students. MBIA Corp. believes that the Royal policies cover losses even if they result from misappropriations of student payments, but in any event it appears that all or substantially all of the claims made under the Royal policies relate to defaults by students rather than misappropriation of funds. Therefore, MBIA Corp. expects Royal to be required to pay all or substantially all of the claims made under its policies and to be reimbursed for any payments MBIA Corp. made under its policies. Royal has requested that the case be reheard *en banc*.

MBIA Corp. believes that it will prevail in the litigation with Royal and will have no ultimate loss on these policies, although there can be no assurance that MBIA Corp. will in fact prevail. If MBIA Corp. does not prevail in the litigation and Royal does not make payments on the Royal policies, MBIA Corp. expects to incur material losses under its policies. MBIA Corp. does not believe, however, that any such losses will have a material adverse effect on its financial condition.

In November 2004, the Company received identical document subpoenas from the SEC and the NYAG requesting information with respect to non-traditional or loss mitigation insurance products developed, offered or sold by the Company to third parties from January 1, 1998 to the present. While the subpoenas did not identify any specific transaction, subsequent conversations with the SEC and the NYAG revealed that the investigation included the arrangements entered into by MBIA Corp. in 1998 in connection with the bankruptcy of the Delaware Valley Obligated Group, an entity that is part of AHERF.

On March 9, 2005, the Company received a subpoena from the U.S. Attorney s Office for the Southern District of New York (U.S. Attorney) seeking information related to the agreements it entered into in connection with the AHERF loss. Thereafter, the Company has received additional subpoenas, substantively identical to each other, and additional informal requests, from the SEC and the NYAG for documents and other information.

On August 19, 2005, the Company received a Wells Notice from the SEC indicating that the staff of the SEC is considering recommending that the SEC bring a civil injunctive action against the Company alleging violations of federal securities laws arising from MBIA s action to retroactively reinsure losses it incurred from the AHERF bonds MBIA had guaranteed, including, but not limited to, its entering into excess of loss agreements and quota share agreements with three separate counterparties.

On November 8, 2005, the Company announced that it was in discussions with the SEC, the NYAG and the NYSID regarding potential settlements of their investigations into agreements entered into by MBIA Corp. in connection with the AHERF matter. In connection with the potential settlements, the Company announced that it was restating its financial statements to correct and restate its GAAP and statutory accounting for 1998 and subsequent years as discussed in Note 2 included herein. In connection with the proposed settlements, the Company accrued $75 million for the total amount the Company estimates, based on discussions to date, it will have to pay in connection with any settlements.

The Company has been cooperating, and is continuing to cooperate fully with the investigations by the SEC, the NYAG, the NYSID and the U.S. Attorney. To date, no settlements have been approved by the regulatory agencies, and no assurance can be given that any settlements will be approved. Any settlements may have additional or different terms.

The Company has been named as a defendant in a consolidated private securities litigation suit: *In re MBIA Inc. Securities Litigation*; (Case No. 05 CV 03514(LLS); S.D.N.Y.) (filed October 3, 2005). Joseph W. Brown, the Company s Chairman and former Chief Executive Officer, Gary C. Dunton, the Company s Chief Executive Officer, Nicholas Ferreri, the Company s Chief Financial Officer, Neil G. Budnick, a Vice President of the Company and the Company s former Chief Financial Officer and Douglas C. Hamilton, the Company s Controller were also named as defendants in the suit, as were former Chairman and Chief Executive Officer David H. Elliot and former Executive Vice President, Chief Financial Officer and Treasurer Julliette S. Tehrani. The plaintiffs assert claims under Section 10(b) of the Securities Exchange Act of 1934 (the Exchange Act), Rule 10b-5 promulgated thereunder, and Section 20(a) of the Exchange Act. The lead plaintiffs act as representatives for a class consisting of purchasers of the Company s stock during the period from August 5, 2003 to March 30, 2005 (the Class Period).

The allegations contained in the lawsuit include, among other things, violations of the federal securities laws arising out of the Company s allegedly false and misleading statements about its financial condition and the nature of the arrangements entered into by MBIA Corp. in connection with the AHERF loss. The plaintiffs allege that, as a result of these misleading statements or omissions, the Company s stock traded at artificially inflated prices. These lawsuits seek unspecified compensatory damages in connection with purchases by members of the class of the Company s stock at such allegedly inflated prices during the Class Period. The Company does not expect the outcome of the private securities litigation to have a material adverse affect on its financial condition, although the outcome is uncertain and no assurance can be given that the Company will not suffer a loss.

Certain officers of the Company and certain members of the Company s Board of Directors have been named as defendants in a shareholder derivative action filed on behalf of the Company in the Supreme Court of New York, Westchester County on November 9, 2005: *Robert Purvis, Derivatively on Behalf of Nominal Defendant MBIA, Inc. v. Joseph W. Brown, Neil G. Budnick, C. Edward Chaplin, David C. Clapp, Clifford D. Corso, Gary C. Dunton, Claire L. Gaudiani, Daniel P. Kearney, Laurence H. Meyer, Debra J. Perry, John A. Rolls, and Ruth M. Whaley* (Case No. 20099-05). The plaintiff asserts claims for the benefit of the Company to redress injuries suffered by the Company as a result of alleged breaches of fiduciary duties by the named defendants in connection with the Company s accounting for certain transactions, including the AHERF loss. In addition, the plaintiff alleges that the officer defendants were unjustly enriched as a result of such alleged breach. The lawsuit seeks disgorgement to the Company of compensation granted to such officers, legal costs and unspecified equitable relief to remedy defendant s breaches of fiduciary duties.

There are no other material lawsuits pending or, to the knowledge of the Company, threatened, to which the Company or any of its subsidiaries is a party.

Table of Contents

Item 9. Changes in and Disagreements With Accountants on Accounting and Financial Disclosure

None.

Item 9A. Controls and Procedures

Evaluation of Disclosure Controls and Procedures

As of the end of the period covered by this report, an evaluation of the effectiveness of the design and operation of the Company s disclosure controls and procedures (as defined in Rule 13a-15(e) under the Securities Exchange Act of 1934) was performed under the supervision and with the participation of the Company s senior management, including the Chief Executive Officer and the Chief Financial Officer. Based on that evaluation, the Company s management, including the Chief Executive Officer and the Chief Financial Officer, concluded that the Company s disclosure controls and procedures were effective as of the end of the period covered by this report.

As required by Rule 13a-15(d) under the Exchange Act, the Company s management, including its Chief Executive Officer and Chief Financial Officer, has evaluated the Company s internal control over financial reporting to determine whether any changes occurred during the fourth fiscal quarter covered by this annual report that have materially affected or are reasonably likely to materially affect, our internal control over financial reporting. Based on that evaluation, there has been no such change during the fourth fiscal quarter of 2005.

As disclosed in Note 2: Restatement Of Consolidated Financial Statements in the Notes to the Consolidated Financial Statements of MBIA Inc. and Subsidiaries, the Company restated its previously issued consolidated financial statements for 1998 and subsequent years to correct and restate its accounting for the excess-of-loss and quota share agreements (the Transactions) entered into with ARF and Munich Re and certain derivatives not qualifying for shortcut method hedge accounting (the Derivative Transactions). In arriving at management s conclusion that internal control over financial reporting and disclosure controls and procedures were effective as of December 31, 2005, the Company completed an analysis under Staff Accounting Bulletin (SAB) 99 for purposes of determining whether the restatements referred to above were material to prior period financial statements included in this filing. Upon consideration of the quantitative and qualitative factors in SAB 99, management concluded that (i) prior period financial statements taken as a whole were not materially misstated; (ii) the cumulative impact of the restatement adjustments on shareholders equity was not material to the financial statements of any interim or annual periods; (iii) management decided to restate the Company s previously issued financial statements for the Transactions, as described herein, in connection with potential settlements of investigations by the SEC and the NYAG s office, taking into account developments in the regulatory investigations and further related accounting analyses; and (iv) as it relates to the Derivative Transactions, the Company concluded that the control deficiency that gave rise to the error was not a material weakness. Furthermore, the Transactions that gave rise to the related restatement were done in 1998 and, because the Company now has effective controls over these transactions, management has concluded that it has effective controls over the accounting for such transactions as of December 31, 2005.

Management s Report on Internal Control over

Financial Reporting

Management of MBIA Inc. and its subsidiaries is responsible for establishing and maintaining adequate internal control over financial reporting. The Company s internal control over financial reporting is a process designed under the supervision of the Company s principal executive and principal financial officers to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external reporting purposes in accordance with accounting principles generally accepted in the United States of America.

MBIA s internal control over financial reporting includes policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect transactions and dispositions of assets; (2) provide reasonable assurances that transactions are recorded as necessary to permit preparation of financial statements in accordance with accounting principles generally accepted in the United States of America, and that receipts and expenditures are being made only in accordance with authorizations of management and the directors of the Company; and, (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use or disposition of the Company s assets that could have a material effect on the Company s financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

As of December 31, 2005, management conducted an assessment of the effectiveness of the Company s internal control over financial reporting based on the framework established in *Internal Control - Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). Based on this assessment and those criteria, management has determined that the Company s internal control over financial reporting as of December 31, 2005 was effective.

Management s assessment of the effectiveness of the Company s internal control over financial reporting as of December 31, 2005 has been audited by PricewaterhouseCoopers LLP, an independent registered public accounting firm, as stated in their report which appears herein.

Item 9B. Other Information

None.

PART III

Item 10. Directors and Executive Officers of the Registrant

Information regarding directors is set forth under Election of Directors in the Company s Proxy Statement to be filed on or before March 31, 2006, which is incorporated by reference.

Information regarding executive officers is set forth under Part I, Item 1, Business - Executive Officers, included in this annual report.

Information concerning the Company s Audit Committee will be set forth under The Board of Directors and its Committees in the Company s Proxy Statement to be filed on or before March 31, 2006, which is incorporated by reference.

The Company has adopted a code of ethics that applies to all employees of the Company including its Chief Executive Officer, Chief Financial Officer and its controller. A copy of such code of ethics can be found on the Company s internet website at www.mbia.com. The Company would intend to satisfy the disclosure requirements under Item 10 of Form 8-K regarding an amendment to, or waiver from, a provision of its code of ethics and that relates to a substantive amendment or material departure from a provision of the Code by posting such information on its internet website at www.mbia.com.

Item 11. Executive Compensation

Information regarding compensation of the Company s executive officers is set forth in the Report of the Compensation and Organization Committee on Executive Compensation and in the five compensation tables in the Company s Proxy Statement to be filed on or before March 31, 2006, which is incorporated by reference.

Item 12. Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters

Information regarding security ownership of certain beneficial owners and management is set forth under Security Ownership of Certain Beneficial Owners and Security Ownership of Directors and Executive Officers and Equity Compensation Plan Information Table in the Company s Proxy Statement to be filed on or before March 31, 2006, which is incorporated by reference.

Item 13. Certain Relationships and Related Transactions

None.

Item 14. Principal Accounting Fees and Services

Information concerning principal accounting fees and services will be set forth under Report of the Audit Committee Principal Accounting Fees and Services in the Company s Proxy Statement to be filed on or before March 31, 2006, which is incorporated by reference.

Table of Contents

PART IV

Item 15. Exhibits, Financial Statement Schedules
(a) Financial Statements and Financial Statement Schedules and Exhibits.

1. Financial Statements

The following financial statements of MBIA Inc. have been included in Part II, Item 8 hereof:

Report of Independent Registered Public Accounting Firm

Consolidated balance sheets as of December 31, 2005 and 2004

Consolidated statements of income for the years ended December 31, 2005; 2004; and 2003.

Consolidated statements of changes in shareholders equity for the years ended December 31, 2005; 2004; and 2003.

Consolidated statements of cash flows for the years ended December 31, 2005; 2004; and 2003.

Notes to consolidated financial statements.

2. Financial Statement Schedules

The following financial statement schedules are filed as part of this report.

Schedule	Title
I.	Summary of investments, other than investments in related parties, as of December 31, 2005.
II.	Condensed financial information of Registrant for December 31, 2005; 2004; and 2003.
IV.	Reinsurance for the years ended December 31, 2005; 2004; and 2003.

The report of the Registrant s Independent Registered Public Accounting Firm with respect to the above listed financial statement schedules is included within the report listed under Item 15.1 above.

All other schedules are omitted because they are not applicable or the required information is shown in the consolidated financial statements or notes thereto.

3. Exhibits

(An exhibit index immediately preceding the Exhibits indicates the page number where each exhibit filed as part of this report can be found.)

1. Underwriting Agreements.

1.1. Underwriting Agreement, dated November 17, 2004, among MBIA Inc. and Lehman Brothers Inc. and J.P. Morgan Securities Inc. as representatives of the underwriters named therein, in connection with the $350,000,000 5.70% senior notes due 2034, incorporated by reference to Exhibit 1.01 to the Company s Current Report on Form 8-K filed on November 29, 2004.

3. Articles of Incorporation and By-Laws.

3.1. Amended and Restated Certificate of Incorporation, dated May 5, 2005, incorporated by reference to Exhibit 3.1 to the Company s Quarterly Report on Form 10-Q for the fiscal quarter ended June 30, 2005 (Comm. File 1-9583).

3.2. By-Laws as Amended as of March 19, 1998, incorporated by reference to Exhibit 3.2 of the 1998 10-K.

Table of Contents

4. Instruments Defining the Rights of Security Holders, including Indentures.

4.1. Indenture, dated as of August 1, 1990, between MBIA Inc. and The First National Bank of Chicago, Trustee, incorporated by reference to Exhibit 10.72 to the 1992 10-K.

4.2. Bond Purchase and Paying Agent Agreement between MBIA Inc. and various banks, entered into as of December 12, 2000 in connection with CHF 175,000,000 4.5% Bonds, due June 15, 2010, incorporated by reference to Exhibit 4.2 to the 2000 10-K.

4.3. Senior Indenture, dated as of November 24, 2004, between MBIA Inc. and The Bank of New York, as Trustee, incorporated by reference to Exhibit 4.01 to the Company s Current Report on Form 8-K filed on November 29, 2004.

4.4. First Supplemental Indenture, dated as of November 24, 2004, between MBIA Inc. and The Bank of New York, as Trustee, in connection with the $350,000,000 5.70% senior notes due 2034, incorporated by reference to Exhibit 4.02 to the Company s Current Report on Form 8-K filed on November 29, 2004.

10. Material Contracts

10.01. Second Amended and Restated Tax Allocation Agreement, dated as of March 11, 2004 between the Company and MBIA Insurance Corporation, incorporated by reference to Exhibit 10.01 to the Company s Annual Report on Form 10-K for the fiscal year ended December 31, 2004 (Comm. File No. 1-9583) (the 2004 10-K).

10.02. Note Subscription Agreement and Preferred Shares Subscription Agreement, both dated as of December 27, 2001 between MBIA Inc. and certain reinsurers, incorporated by reference to Exhibit 10.02 to the Company s Annual Report on Form 10-K for the fiscal year ended December 31, 2001 (Comm. File No. 1-9583) (the 2001 10-K).

10.03. Trust Agreement, dated as of December 31, 1991, between MBIA Corp. and Fidelity Management Trust Company, incorporated by reference to Exhibit 10.64 to the 1992 10-K, as amended by the Amendment to Trust Agreement, dated as of April 1, 1993, incorporated by reference to Exhibit 10.64 to the 1993 10-K, as amended by First Amendment to Trust Agreement, dated as of January 21, 1992, as further amended by Second Amendment to Trust Agreement, dated as of March 5, 1992, as further amended by Third Amendment to Trust Agreement, dated as of April 1, 1993, as further amended by the Fourth Amendment to Trust Agreement, dated as of July 1, 1995, incorporated by reference to Exhibit 10.47 to the Company s Annual Report on Form 10-K for the fiscal year ended December 31, 1995 (Comm. File No. 1-9583) (the 1995 10-K), as amended by Fifth Amendment to Trust Agreement, dated as of November 1, 1995, as further amended by Sixth Amendment to Trust Agreement, dated as of January 1, 1996, incorporated by reference to Exhibit 10.46 to the 1996 10-K, further amended by Seventh Amendment to Trust Agreement, dated as of October 15, 1997, incorporated by reference to Exhibit 10.36 of the Company s Annual Report on Form 10-K for the fiscal year ended December 31, 1997 (Comm. File No. 1-9583) (the 1997 10-K) as further amended by the Eighth Amendment to Trust Agreement, dated as of January 1, 1998 and by the Ninth Amendment to Trust Agreement, dated as of March 1, 1999, incorporated by reference to Exhibit 10.10 to the Company s Annual Report on Form 10-K for the fiscal year ended December 31, 1998 (Comm. File No. 1-9583) (the 1998 10-K).

10.04. First Restated Credit Agreement, dated as of October 1, 1993, among MBIA Corp., Credit Suisse, New York Branch, as Agent, Credit Suisse, New York Branch, Caisse Des Depots Et Consignations, Deutsche Bank AG, Bayerische Landesbank Girozentrale and Landesbank Hessen-Thuringen Girozentrale, as amended by an Assignment and Assumption Agreement, dated as of December 31, 1993, among MBIA Corp., Credit Suisse, New York Branch, as Agent and Assignor and Deutsche Bank AG, New York Branch, as further amended by a Modification Agreement, dated as of January 1, 1994, among Deutsche Bank, AG, New York Branch, MBIA Corp. and Credit Suisse, New York Branch, as Agent, as amended by a Joinder Agreement, dated December 31, 1993, among Credit Suisse, New York Branch, as Agent, Sudwestdeutsche Landesbank Girozentrale and MBIA Corp., incorporated by reference to Exhibit 10.78 to the 1993 10-K, as amended by the First Amendment to First Restated Credit Agreement, dated as of September 23, 1994, incorporated by reference to Exhibit 10.63 to the 1994 10-K, as further amended by the Second Amendment to the First Restated Credit Agreement, dated as of January 1, 1996, and as further amended by the Third Amendment to the First Restated Credit Agreement, dated as of October 1, 1996, incorporated by reference to Exhibit 10.57 to the 1996 10-K, as further amended and restated by the Second Amended and Restated Credit Agreement, dated as of October 1, 1997, incorporated by reference to Exhibit 10.46 to the 1997 10-K, as further amended by the First Amendment to Second Amended and Restated Credit Agreement, dated as of October 1, 1998, incorporated by reference to Exhibit 10.13 to the 1998 10-K, as further amended and restated by the Second Amendment to the Second Amended and Restated Credit Agreement, dated as of October 29, 1999, incorporated by reference to Exhibit 10.13 to the 1999 10-K, as further amended and restated by the Third Amendment to the Second Amended and Restated Credit Agreement, dated as of October 27, 2000, incorporated by reference to Exhibit 10.04 to the 2000 10-K, as further amended by the Fourth Amendment to the Second Amended and Restated Credit Agreement, dated as of October 31, 2001, incorporated by reference to Exhibit 10.04

to the 2001 10-K, as further amended and restated by the Third Amended and Restated Credit Agreement, dated as of October 31, 2002, incorporated by reference to Exhibit 10.04 to the 2002 10-K, as further amended

by the First Amendment to the Third Amended and Restated Credit Agreement dated as of October 31, 2003, incorporated by reference to Exhibit 10.04 to the Company s Annual Report on Form 10-K for the fiscal year ended December 31, 2003 (Comm. File 1-9583) (the 2003 10-K) as further amended and restated by the Fourth Amended and Restated Credit Agreement, effective March 31, 2005, incorporated by reference to Exhibit 10.04 to the Company s Current Report on Form 8-K filed on April 5, 2005.

10.05. Net Worth Maintenance Agreement, dated as of November 1, 1991, between MBIA Corp. and MBIA Assurance S.A., as amended by Amendment to Net Worth Agreement, dated as of November 1, 1991, incorporated by reference to Exhibit 10.79 to 1993 10-K, as further amended and restated by the Amended and Restated Net Worth Maintenance Agreement, dated as of April 1, 2002, incorporated by reference to Exhibit 10.05 to the 2002 10-K.

10.06. Reinsurance Agreement, dated as of January 1, 1993, between MBIA Assurance S.A. and MBIA Corp., incorporated by reference to Exhibit 10.80 to the 1993 10-K, as amended and restated by the Amended and Restated Reinsurance Agreement, dated as of January 1, 2002, incorporated by reference to Exhibit 10.06 to the 2002 10-K.

10.07. Investment Services Agreement, effective as of April 28, 1995, between MBIA Insurance Corporation and MBIA Securities Corp., as amended by Amendment No. 1, dated as of December 29, 1995, incorporated by reference to Exhibit 10.65 to the 1995 10-K, as amended by Amendment No. 2, dated January 14, 1997, incorporated by reference to Exhibit 10.53 to the 1997 10-K, as amended by Amendment No. 3, dated September 10, 2001, as further amended by Amendment No. 4 dated as of January 2, 2003, incorporated by reference to Exhibit 10.07 to the 2004 10-K.

10.08. Investment Services Agreement, effective January 2, 1996, between MBIA Insurance Corp. of Illinois and MBIA Securities Corp., incorporated by reference to Exhibit 10.66 to the 1995 10-K, as amended by Amendment No. 1, dated as of January 2, 2003, , incorporated by reference to Exhibit 10.08 to the 2004 10-K.

10.09. Agreement and Plan of Merger among the Company, CMA Acquisition Corporation and CapMAC Holdings Inc. (CapMAC), dated as of November 13, 1997, incorporated by reference to the Company s Form S-4 (Reg. No. 333-41633) filed on December 5, 1997.

10.10. Amendment No. 1 to Agreement and Plan of Merger among the Company, CMA Acquisition Corporation and CapMAC Holdings Inc. (CapMAC), dated January 16, 1998, incorporated by reference to the Company s Post Effective Amendment No. 1 to Form S-4 (Reg. No. 333-41633) filed on January 21, 1998.

10.11. Reinsurance Agreement, dated as of April 1, 1998, between CapMAC and MBIA Corp., incorporated by reference to Exhibit 10.30 to the 1998 10-K.

10.12. Reinsurance Agreement, dated as of January 1, 1999, between MBIA Illinois and MBIA Corp., incorporated by reference to Exhibit 10.31 to the 1998 10-K.

10.13. Agreement and Plan of Merger by and among the Company, MBIA Acquisition, Inc. and 1838 Investment Advisors, Inc., dated as of June 19, 1998, incorporated by reference to Exhibit 10.32 to the 1998 10-K.

10.14. Credit Agreement (364 day agreement) among the Company, MBIA Corp., various designated borrowers, various lending institutions, Deutsche Bank AG, New York Branch, as Administrative Agent, The First National Bank of Chicago, as Syndication Agent and Fleet National Bank, as Documentation Agent, dated as of August 28, 1998, incorporated by reference to Exhibit 10.33 to the 1998 10-K, as amended by a Notice of Extension of Final Maturity Date, with various lending institutions, dated as of August 2000, incorporated by reference to Exhibit 10.14 to the 2000 10-K, as further amended by the First Amendment, dated as of February 9, 2001, the Second Amendment to the Credit Agreement, dated as of July 31, 2001, and the Third Amendment, dated as of December 7, 2001, incorporated by reference to Exhibit 10.14 to the 2001 10-K, as amended and restated by the Amended and Restated Credit Agreement, dated as of April 19, 2002, incorporated by reference to Exhibit 10.14 to the 2002 10-K, as further amended and restated by the Second Amended and Restated Credit Agreement, dated as of April 16, 2003, incorporated by reference to Exhibit 10.14 to the 2003 10-K.

10.15. Credit Agreement (5 year agreement) among the Company, MBIA Corp., various designated borrowers, various lending institutions, Deutsche Bank AG, New York Branch, as Administrative Agent, The First National Bank of Chicago, as Syndication Agent and Fleet National Bank, as Documentation Agent, dated as of August 28, 1998, incorporated by reference to Exhibit 10.34 to the 1998 10-K, as amended by a Notice of Extension of Final Maturity Date, with various lending institutions, dated as of August 2000, incorporated by reference to Exhibit 10.15 to the 2000 10-K as further amended by the First Amendment, dated as of February 9, 2001, the Second Amendment to the Credit Agreement, dated as of July 31, 2001, and the Third Amendment, dated as of December 7, 2001, incorporated by reference to Exhibit 10.15 to

the 2001 10-K, as amended and restated by the Amended and

Table of Contents

Restated Credit Agreement, dated as of April 19, 2002, incorporated by reference to Exhibit 10.15 to the 2002 10-K, as further amended and restated by the Second Amended and Restated Credit Agreement, dated as of April 16, 2003, incorporated by reference to Exhibit 10.15 to the 2003 10-K.

10.16. Advances Agreement between MBIA Corp., its affiliates and MBIA Inc., dated as of January 1, 2001, incorporated by reference to Exhibit 10.16 to the 2002 10-K.

10.17. Special Excess Of Loss Reinsurance Agreement, between MBIA Insurance Corporation and/or MBIA Assurance S.A. and/or any other insurance or reinsurance company subsidiaries of MBIA Inc. listed in Exhibit No. 1 and Muenchener Rueckversicherungs-Gesellshaft, effective September 1, 1998, incorporated by reference to Exhibit 10.49 to the 1998 10-K.

10.18. Second Special Per Occurrence Excess Of Loss Reinsurance Agreement, between MBIA Insurance Corporation and/or MBIA Assurance S.A. and/or any other insurance or reinsurance company subsidiaries of MBIA Inc. listed in Exhibit No. 1 and AXA Re Finance S.A., effective September 1, 1998, incorporated by reference to Exhibit 10.50 to the 1998 10-K.

10.19. ISDA Master Agreement, dated May 2, 2000, between Deutsche Bank AG and MBIA Inc., as supplemented by the Schedule to the ISDA Master Agreement and the Credit Support Annex, incorporated by reference to Exhibit 10.19 to the 2000 10-K.

10.53. Put Option Agreement between MBIA Insurance Corporation and North Castle Custodial Trust I, dated as of December 23, 2002, incorporated by reference to Exhibit 10.53 to the 2002 10-K.

10.54. Put Option Agreement between MBIA Insurance Corporation and North Castle Custodial Trust II, dated as of December 23, 2002, incorporated by reference to Exhibit 10.54 to the 2002 10-K.

10.55. Put Option Agreement between MBIA Insurance Corporation and North Castle Custodial Trust III, dated as of December 23, 2002, incorporated by reference to Exhibit 10.55 to the 2002 10-K.

10.56. Put Option Agreement between MBIA Insurance Corporation and North Castle Custodial Trust IV, dated as of December 23, 2002, incorporated by reference to Exhibit 10.56 to the 2002 10-K.

10.57. Put Option Agreement between MBIA Insurance Corporation and North Castle Custodial Trust V, dated as of May 14, 2003, incorporated by reference to Exhibit 10.57 to the 2003 10-K.

10.58. Put Option Agreement between MBIA Insurance Corporation and North Castle Custodial Trust VI, dated as of May 14, 2003, incorporated by reference to Exhibit 10.58 to the 2003 10-K

10.59. Put Option Agreement between MBIA Insurance Corporation and North Castle Custodial Trust VII, dated as of May 14, 2003, incorporated by reference to Exhibit 10.59 to the 2003 10-K.

10.60. Put Option Agreement between MBIA Insurance Corporation and North Castle Custodial Trust VIII, dated as of May 14, 2003, incorporated by reference to Exhibit 10.60 to the 2003 10-K.

10.72. Amended and Restated Net Worth Maintenance Agreement, dated as of October 12, 2004, between MBIA Insurance Corporation, MBIA UK (Holdings) Limited and MBIA UK Insurance Ltd., incorporated by reference to Exhibit 10.72 to the 2004 10-K.

10.73. Excess of Loss Reinsurance Agreement, dated as of May 14, 2004, between MBIA UK Insurance Ltd. and MBIA Insurance Corporation, incorporated by reference to Exhibit 10.73 to the 2004 10-K.

10.76. Second Amendment to the Second Amended and Restated Credit Agreement among MBIA Inc., MBIA Insurance Corporation, various designated borrowers, various lending institutions, Barclays Capital, as Joint Lead Arranger,

Banc of America Securities LLC, as Joint Lead Arranger, Barclays Bank PLC, as Administrative Agent, Bank of America, N.A. as Syndication Agent, and KeyBank National Association, JPMorgan Chase Bank and The Bank of New York as Co-Documentation Agents, dated as of April 14, 2005, incorporated by reference to Exhibit 10.01 to the Company s Current Report on Form 8-K filed on April 22, 2005 (Comm. File 1-9583).

Executive Compensation Plans and Arrangements

The following Exhibits identify all existing executive compensation plans and arrangements:

10.20 MBIA Inc. 2000 Stock Option Plan, effective May 11, 2000, incorporated by reference to Exhibit 10.20 to the 2000 10-K.

10.21. MBIA Inc. Deferred Compensation and Excess Benefit Plan, incorporated by reference to Exhibit 10.16 to the Company s Annual Report on Form 10-K for the fiscal year ended December 31, 1988 (Comm. File No. 1-9583) (the 1988 10-K), as amended as of July 22, 1992, incorporated by reference to Exhibit 10.15 to the Company s Annual Report on Form 10-K for the fiscal year ended December 31, 1992 (Comm. File No. 1-9583) (the 1992 10-K).

10.22. MBIA Inc. Employees Pension Plan, amended and restated effective January 1, 1987, incorporated by reference to Exhibit 10.28 of the Company s Amendment No. 1 to the 1987 S-1, as further amended and restated as of December 12, 1991, incorporated by reference to Exhibit 10.18 to the Company s Annual Report on Form 10-K for the fiscal year ended December 31, 1991 (Comm. File No. 1-9583) (the 1991 10-K), as further amended and restated effective January 1, 1994, incorporated by reference to Exhibit 10.16 of the Company s Annual Report on Form 10-K for fiscal year ended December 31, 1994 (Comm. File No. 1-9583) (the 1994 10-K)), as further amended by Amendment as of January 1, 2002, incorporated by reference to Exhibit 10.22 to the 2002 10-K.

10.23. MBIA Inc. Employees Profit Sharing Plan, as amended and restated effective January 1, 1987, incorporated by reference to Exhibit 10.29 to Amendment No. 1 to the 1987 S-1, as further amended by Amendment dated December 8, 1988, incorporated by reference to Exhibit 10.21 to the Company s Annual Report on Form 10-K for the fiscal year ended December 31, 1989 (Comm. File No. 1-9583) (the 1989 10-K), as further amended and restated as of December 12, 1991, incorporated by reference to Exhibit 10.19 to the 1991 10-K, as further amended and restated as of May 7, 1992, incorporated by reference to Exhibit 10.17 to the 1992 10K, as further amended and restated effective January 1, 1994, incorporated by reference to Exhibit 10.17 to the 1994 10-K, as further amended by Amendment as of January 1, 2002, incorporated by reference to Exhibit 10.23 to the 2002 10-K.

10.25. MBIA Inc. Employees Change of Control Benefits Plan, effective as of January 1, 1992, incorporated by reference to Exhibit 10.65 to the 1992 10-K.

10.26. MBIA Inc. 1996 Incentive Plan, effective as of January 1, 1996, incorporated by reference to Exhibit 10.70 to the 1995 10-K.

10.27. MBIA Inc. 1996 Directors Stock Unit Plan, effective as of December 4, 1996, incorporated by reference to Exhibit 10.70 to the 1996 10-K.

10.28. CapMAC Employee Stock Ownership Plan, incorporated by reference to Exhibit 10.18 to the CapMAC Form S-1, as Amended and Restated, effective January 1, 1999, incorporated by reference to Exhibit 10.28 to the 2000 10-K.

10.29. CapMAC Employee Stock Ownership Plan Trust Agreement, incorporated by reference to Exhibit 10.19 to the CapMAC Form S-1, as amended by Amendment No. 2 to the CapMAC Employee Stock Ownership Plan, executed December 22, 1998, incorporated by reference to Exhibit 10.25 to the 1998 10-K.

10.30. ESOP Loan Agreement by and between MBIA Inc. and the CapMAC Employee Stock Ownership Plan Trust, dated June 30, 1999, incorporated by reference to Exhibit 10.30 to the 2000 10-K.

10.31. Deferred Compensation and Restricted Stock Agreement, dated as of December 7, 1995, between John B. Caouette and CapMAC, incorporated by reference to Exhibit 10.28 of the CapMAC Annual Report on Form 10-K for the year ended December 31, 1995 (the CapMAC 1995 10-K).

10.32. Deferred Compensation and Restricted Stock Agreement, dated as of December 7, 1995, between Ram D. Wertheim and CapMAC, incorporated by reference to Exhibit 10.35 of the CapMAC 1995 10-K.

10.34. Terms of Employment letter between MBIA and Joseph W. Brown, Jr., dated January 7, 1999, incorporated by reference to Exhibit 10.36 to the 1998 10-K.

Table of Contents

10.35. Stock Option Agreement between MBIA Inc. and Joseph W. Brown, Jr., dated January 7, 1999, incorporated by reference to Exhibit 10.37 to the 1998 10-K.

10.36. Key Employee Employment Protection Agreement between MBIA Inc. and Joseph W. Brown, Jr., dated January 20, 1999, incorporated by reference to Exhibit 10.38 to the 1998 10-K.

10.37. Key Employee Employment Protection Agreement between MBIA Inc. and Neil G. Budnick, dated January 25, 1999, incorporated by reference to Exhibit 10.39 to the 1998 10-K.

10.38. Key Employee Employment Protection Agreement between MBIA Inc. and W. Thacher Brown, dated January 25, 1999, incorporated by reference to Exhibit 10.40 to the 1998 10-K.

10.39. Key Employee Employment Protection Agreement between MBIA Inc. and John B. Caouette, dated January 25, 1999, incorporated by reference to Exhibit 10.41 to the 1998 10-K.

10.40. Key Employee Employment Protection Agreement between MBIA Inc. and Gary C. Dunton, dated January 25, 1999, incorporated by reference to Exhibit 10.42 to the 1998 10-K.

10.41. Key Employee Employment Protection Agreement between MBIA Inc. and Louis G. Lenzi, dated January 25, 1999, incorporated by reference to Exhibit 10.43 to the 1998 10-K.

10.42. Key Employee Employment Protection Agreement between MBIA Inc. and Kevin D. Silva, dated January 25, 1999, incorporated by reference to Exhibit 10.44 to the 1998 10-K.

10.43. Key Employee Employment Protection Agreement between MBIA Inc. and Richard L. Weill, dated January 25, 1999, incorporated by reference to Exhibit 10.45 to the 1998 10-K.

10.44. Key Employee Employment Protection Agreement between MBIA Inc. and Ruth M. Whaley, dated January 25, 1999, incorporated by reference to Exhibit 10.46 to the 1998 10-K.

10.45. Key Employee Employment Protection Agreement between MBIA Inc. and Michael J. Maguire, dated March 19, 1999, incorporated by reference to Exhibit 10.47 to the 1998 10-K.

10.46. Key Employee Employment Protection Agreement between MBIA Inc. and John S. Pizzarelli, dated March 14, 2000, incorporated by reference to Exhibit 10.46 to the 2000 10-K.

10.47. Key Employee Employment Protection Agreement between MBIA Inc. and Ram D. Wertheim, dated January 24, 2000, incorporated by reference to Exhibit 10.47 to the 2000 10-K.

10.48. Key Employee Employment Protection Agreement between MBIA Inc. and Robert T. Wheeler, dated April 17, 2000, incorporated by reference to Exhibit 10.48 to the 2000 10-K.

10.49. Key Employee Employment Protection Agreement between MBIA Inc. and Mark S. Zucker, dated March 14, 2000, incorporated by reference to Exhibit 10.49 to the 2000 10-K.

10.50. MBIA Inc. Restricted Stock Plan for Non-Employee Directors, effective as of March 21, 2002, incorporated by reference to the MBIA Inc. Form S-8 filed on March 14, 2002 (Reg. No. 333-84300) (the 2002 S-8).

10.51. Amended and Restated Deferred Compensation and Stock Ownership Plan for Non-Employee Directors, effective as of March 21, 2002, incorporated by reference to the 2002 S-8.

10.52. MBIA Inc. Annual and Long-Term Incentive Plan, effective as of January 1, 2002, incorporated by reference to Exhibit 10.52 of the 2002 10-K, as amended by Amendment No. 1 dated as of February 10, 2004, incorporated by reference to Exhibit 10.52 to the 2003 10-K.

10.61. Form of Restricted Stock Agreement for Chief Executive Officer, incorporated by reference to Exhibit 10.61 to the 2003 10-K.

10.62. Form of Restricted Stock Agreement for Directors, incorporated by reference to Exhibit 10.62 to the 2003 10-K.

10.63. Form of Restricted Stock Agreement for Executive Officers, incorporated by reference to Exhibit 10.63 to the 2003 10-K.

10.64. Form of Stock Option Agreement for Chief Executive Officer and President, incorporated by reference to Exhibit 10.64 to the 2003 10-K.

10.65 Form of Stock Option Agreement for Executive Officers, incorporated by reference to Exhibit 10.65 to the 2003 10-K.

10.66 Letter Agreement dated May 6, 2004 by and between MBIA Inc. and Joseph W. Brown, incorporated by reference to Exhibit 10.66 to the Company s Current Report on Form 8-K filed on May 7, 2004.

10.67 Letter Agreement dated May 6, 2004 by and between MBIA Inc. and Gary C. Dunton, incorporated by reference to Exhibit 10.67 to the Company s Current Report on Form 8-K filed on May 7, 2004.

10.68 Restricted Stock Agreement dated as of May 6, 2004 by and between MBIA Inc. and Joseph W. Brown, incorporated by reference to Exhibit 10.68 to the Company s Current Report on Form 8-K filed on May 7, 2004.

10.69 Restricted Stock Agreement dated as of May 6, 2004 by and between MBIA Inc. and Gary C. Dunton, incorporated by reference to Exhibit 10.69 to the Company s Current Report on Form 8-K filed on May 7, 2004.

10.70. Letter Agreement by and between Richard L. Weill and MBIA Insurance Corporation, effective June 30, 2004, incorporated by reference to Exhibit 10.70 to the 2004 10-K.

10.71. Agreement and General Release by and between Richard L. Weill and MBIA Insurance Corporation, effective June 30, 2004, incorporated by reference to Exhibit 10.71 to the 2004 10-K.

10.74. Letter Agreement by and between John B. Caouette and MBIA Insurance Corporation, effective December 24, 2004, incorporated by reference to Exhibit 10.66 to the Company s Current Report on Form 8-K filed on December 29, 2004.

10.75. Agreement and General Release by and between John B. Caouette and MBIA Insurance Corporation, effective December 24, 2004, incorporated by reference to Exhibit 10.67 to the Company s Current Report on Form 8-K filed on December 29, 2004.

10.77. MBIA Inc. Annual Incentive Plan, effective January 1, 2006, incorporated by reference to Appendix C to the Company s Proxy Statement filed on March 30, 2005.

10.78. MBIA Inc. 2005 Omnibus Incentive Plan, effective May 5, 2005, incorporated by reference to Appendix D to the Company s Proxy Statement filed on March 30, 2005.

+ 10.79 Form of Restricted Stock Agreement.

+21. List of Subsidiaries.

+23. Consent of PricewaterhouseCoopers LLP.

+31.1 Chief Executive Officer Sarbanes-Oxley Act of 2002 Section 302.

+31.2 Chief Financial Officer Sarbanes-Oxley Act of 2002 Section 302.

*32.1 Chief Executive Officer Sarbanes-Oxley Act of 2002 Section 906.

*32.2 Chief Financial Officer Sarbanes-Oxley Act of 2002 Section 906.

+99.1 Additional Exhibits MBIA Corp. GAAP Financial Statements.

\+ Filed Herewith

* Furnished Herewith

Table of Contents

SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, the Registrant has caused this Report to be signed on its behalf by the undersigned, thereunto duly authorized.

MBIAInc.

(Registrant)

Dated: March 8, 2006

By /s/ Gary C. Dunton
Name: Gary C. Dunton
Title: Chief Executive Officer

Pursuant to the requirements of the Securities Exchange Act of 1934, this Report has been signed below by the following persons on behalf of the Registrant and in the capacities and on the dates indicated.

Signature	Title	Date
/s/ Joseph W. Brown	Chairman and Director	March 8, 2006
Joseph W. Brown		
/s/ Nicholas Ferreri	Vice President and Chief Financial Officer	March 8, 2006
Nicholas Ferreri		
/s/ Douglas C. Hamilton	Assistant Vice President and Controller	March 8, 2006
Douglas C. Hamilton		
/s/ C. Edward Chaplin	Director	March 8, 2006
C. Edward Chaplin		
/s/ David C. Clapp	Director	March 8, 2006
David C. Clapp		
/s/ Gary C. Dunton	Director and Chief Executive Officer	March 8, 2006
Gary C. Dunton		
/s/ Claire L. Gaudiani	Director	March 8, 2006
Claire L. Gaudiani		
/s/ Daniel P. Kearney	Director	March 8, 2006
Daniel P. Kearney		

/s/ Laurence H. Meyer	Director	March 8, 2006
Laurence H. Meyer		
/s/ Debra J. Perry	Director	March 8, 2006
Debra J. Perry		
/s/ John A. Rolls	Director	March 8, 2006
John A. Rolls		
/s/ Jeffrey W. Yabuki	Director	March 8, 2006
Jeffrey W. Yabuki		

127

Table of Contents

SCHEDULE I

MBIA INC. AND SUBSIDIARIES

SUMMARY OF INVESTMENTS, OTHER THAN INVESTMENTS IN RELATED PARTIES

December 31, 2005

(In thousands)

Column A	**Column B**	**Column C**	**Column D**
Type of investment	**Cost**	**Fair Value**	**Amount at which shown in the balance sheet**
Fixed-maturity:			
Available-for-sale			
United States Treasury and Government agency obligations	$ 358,984	$ 371,668	$ 371,668
Foreign governments	598,485	635,446	635,446
State and municipal obligations	5,112,628	5,318,308	5,318,308
Corporate and other obligations	14,993,730	15,336,982	15,336,982
Mortgage-backed	2,837,911	2,813,872	2,813,872
Total available-for-sale	23,901,738	24,476,276	24,476,276
Held-to-maturity			
Corporate and other obligations	4,853,929	4,823,082	4,853,929
Mortgage-backed	911,253	911,253	911,253
Total held-to-maturity	5,765,182	5,734,335	5,765,182
Total fixed-maturity	29,666,920	30,210,611	30,241,458
Short-term investments	1,678,281	1,678,281	1,678,281
Other investments	227,206	234,927	234,927
Total investments	$ 31,572,407	$ 32,123,819	$ 32,154,666

128

Table of Contents

SCHEDULE II

MBIA INC. (PARENT COMPANY)

CONDENSED BALANCE SHEETS

(In thousands, except per share amounts)

	December 31, 2005	December 31, 2004
ASSETS		
Investments:		
Fixed-maturity securities held as available-for-sale, at fair value (amortized cost $13,574,097 and $10,137,505)	$ 13,795,453	$ 10,468,119
Investment agreement portfolio pledged as collateral, at fair value (amortized cost $712,054 and $713,704)	729,072	730,870
Short-term investments, at amortized cost (which approximates fair value)	778,569	1,305,976
Other investments	42,256	36,437
Total investments	15,345,350	12,541,402
Cash and cash equivalents	51,617	102,244
Investment in wholly-owned subsidiaries	7,208,775	6,686,661
Intercompany loan receivable	636,667	672,411
Accrued investment income	213,741	138,137
Receivable for investments sold	70,037	64,529
Derivative assets	185,277	231,564
Other assets	192,170	142,421
Total assets	$ 23,903,634	$ 20,579,369
LIABILITIES AND SHAREHOLDERS EQUITY		
Liabilities:		
Investment agreements	$ 10,498,051	$ 8,343,655
Securities sold under agreements to repurchase	649,716	649,281
Long-term debt	1,205,855	1,326,990
Intercompany loan payable	4,178,569	3,147,056
Deferred income taxes, net	94,846	106,584
Payable for investments purchased	21,008	78,895
Dividends payable	37,541	33,489
Derivative liabilities	223,861	156,715
Other liabilities	402,543	177,907
Total liabilities	17,311,990	14,020,572
Shareholders Equity:		
Preferred stock, par value $1 per share; authorized shares - 10,000,000; issued and outstanding shares - none		
Common stock, par value $1 per share; authorized shares - 400,000,000; issued shares - 155,601,779 and 155,607,737	156,602	155,608
Additional paid-in capital	1,479,447	1,410,799
Retained earnings	5,747,171	5,187,484
Accumulated other comprehensive income, net of deferred income tax of $238,881 and $321,565	399,381	618,606
Unearned compensation - restricted stock	(43,857)	(34,686)
Treasury stock, at cost - 22,554,528 shares in 2005 and 16,216,405 shares in 2004	(1,147,100)	(779,014)

Total shareholders equity	6,591,644	6,558,797
Total liabilities and shareholders equity	$ 23,903,634	$ 20,579,369

The condensed financial statements should be read in conjunction with the

consolidated financial statements and notes thereto and the accompanying notes.

Table of Contents

SCHEDULE II

MBIA INC. (PARENT COMPANY)

CONDENSED STATEMENTS OF INCOME

(In thousands)

	Years Ended December 31		
	2005	**2004**	**2003**
Revenues:			
Operating income	$ 86,188	$ 70,443	$ 56,747
Net investment income	27,343	24,379	18,696
Net realized gains (losses)	642	(2,282)	26,905
Net gains (losses) on derivative instruments	21,901	(9,521)	(12,098)
Total revenues	136,074	83,019	90,250
Expenses:			
Interest expense	92,999	74,699	68,691
Penalties and disgorgement	75,000		
Operating expenses	30,505	24,266	22,711
Total expenses	198,504	98,965	91,402
Gain (loss) before income taxes and equity in earnings of subsidiaries	(62,430)	(15,946)	(1,152)
Income tax provision (benefit)	(584)	(2,382)	(1,117)
Gain (loss) before equity in earnings of subsidiaries	(61,846)	(13,564)	(35)
Equity in earnings of subsidiaries	772,832	856,610	825,387
Net income	$ 710,986	$ 843,046	$ 825,352

The condensed financial statements should be read in conjunction with the

consolidated financial statements and notes thereto and the accompanying notes.

Table of Contents

SCHEDULE II

MBIA INC. (PARENT COMPANY)

CONDENSED STATEMENTS OF CASH FLOWS

(In thousands)

	Years Ended December 31		
	2005	**2004**	**2003**
Cash flows from operating activities:			
Net income	$ 710,986	$ 843,046	$ 825,352
Adjustments to reconcile net income to net cash provided by operating activities:			
Equity in earnings of subsidiaries	(772,832)	(856,610)	(825,387)
Dividends from subsidiaries	95,000	747,300	240,000
Increase in accrued investment income	(75,604)	(35,191)	(22,070)
Amortization of bond discount, net	24,826	27,078	27,287
Net realized losses (gains) on sale of investments	(642)	2,282	(26,905)
Deferred income tax provision (benefit)	809	9,498	(2,354)
Net (gains) losses on derivative instruments	(21,901)	9,521	12,098
Stock option compensation	19,421	19,536	26,428
Penalties and disgorgement	75,000		
Accrued interest payable	55,866	7,107	(1,019)
Other, net	39,408	(3,995)	(68,431)
Total adjustments to net income	(560,649)	(73,474)	(640,353)
Net cash provided by operating activities	150,337	769,572	184,999
Cash flows from investing activities:			
Purchase of fixed-maturity securities, net of payable for investments purchased	(12,606,239)	(11,730,609)	(12,551,700)
Sale of fixed-maturity securities, net of receivable for investments sold	9,196,535	8,383,227	11,627,573
Sale (purchase) of short-term investments	472,368	(374,596)	(18,104)
Purchase of other investments	(9,768)	(30,933)	
Contributions to subsidiaries	(20,000)	(20,500)	(27,356)
Advances to subsidiaries, net	(20,119)	(25,391)	(31,729)
Other	(340)		
Net cash used by investing activities	(2,987,563)	(3,798,802)	(1,001,316)
Cash flows from financing activities:			
Proceeds from issuance of investment agreements and medium-term notes	4,209,459	5,160,019	4,125,755
Payments for drawdowns of investment agreements and medium-term notes	(1,893,940)	(3,327,142)	(3,443,938)
Securities sold under agreements to repurchase, net	435	147,883	(39,843)
Net proceeds from issuance of long-term debt		348,548	
Net repayment from retirement of long-term debt	(100,000)	(50,000)	
Proceeds from affiliate loan	1,067,257	1,251,109	350,661
Dividends paid	(147,247)	(132,072)	(110,999)
Capital issuance costs	(2,899)	(2,353)	(4,056)
Other borrowings			30,000
Purchase of treasury stock	(369,715)	(375,030)	(82,404)
Exercise of stock options	23,249	63,390	25,806
Net cash provided by financing activities	2,786,599	3,084,352	850,982

Net (decrease) increase in cash and cash equivalents		(50,627)		55,122		34,665
Cash and cash equivalents - beginning of year		102,244		47,122		12,457
Cash and cash equivalents - end of year	$	51,617	$	102,244	$	47,122
Supplemental cash flow disclosures:						
Income taxes paid (refunded)	$	(29)	$	5,803	$	(1,110)
Interest paid:						
Long-term debt	$	86,850	$	70,388	$	69,876
Other borrowings	$	1,003	$	463		

The condensed financial statements should be read in conjunction with the

consolidated financial statements and notes thereto and the accompanying notes.

131

Table of Contents

SCHEDULE II

MBIA INC. (PARENT COMPANY)

NOTES TO CONDENSED FINANCIAL STATEMENTS

1. Condensed Financial Statements

Certain information and footnote disclosures normally included in financial statements prepared in accordance with accounting principles generally accepted in the United States of America have been condensed or omitted. It is suggested that these condensed financial statements be read in conjunction with the Company s consolidated financial statements and the notes thereto.

2. Significant Accounting Policies

The Parent Company carries its investments in subsidiaries under the equity method.

3. Dividends from Subsidiaries

During 2005 and 2004, MBIA Insurance Corporation declared and paid dividends of $95.0 million and $747.3 million to MBIA Inc.

4. Obligations under Investment Agreement, Commercial Paper and Medium-Term Notes

The investment agreement business, as described in footnotes 3 and 20 to the consolidated financial statements of MBIA Inc. and subsidiaries is conducted by both the Registrant and its wholly owned subsidiary, MBIA Investment Management Corp.

Table of Contents

SCHEDULE IV

MBIA INC. AND SUBSIDIARIES

REINSURANCE

Years Ended December 31, 2005, 2004 and 2003

(In thousands)

Column A	Column B	Column C	Column D	Column E	Column F
	Direct	Ceded to Other	Assumed from		Percentage of Amount
Insurance Premiums Written	Amount	Value	Other Companies	Net Amount	Assumed to Net
2005	$ 972,017	$ 127,107	$ 12,891	$ 857,801	1.5%
2004	$ 1,100,234	$ 158,831	$ 16,681	$ 958,084	1.7%
2003	$ 1,249,832	$ 193,889	$ 18,976	$ 1,074,919	1.8%

133

Securities and Exchange Commission

Washington, D.C. 20549

Exhibits

to

Form 10-K

Annual Report Pursuant to Section 13 or 15(d)

of the Securities Exchange Act of 1934

For the fiscal year ended December 31, 2005

Commission File No. 1-9583

MBIA Inc.

Exhibit Index

10.79	Form of Restricted Stock Agreement
21.	List of Subsidiaries.
23.	Consent of PricewaterhouseCoopers LLP.
31.1	Chief Executive Officer Sarbanes-Oxley Act of 2002 Section 302.
31.2	Chief Financial Officer Sarbanes-Oxley Act of 2002 Section 302.
*32.1	Chief Executive Officer Sarbanes-Oxley Act of 2002 Section 906.
*32.2	Chief Financial Officer Sarbanes-Oxley Act of 2002 Section 906.
99.1	Additional Exhibits MBIA Insurance Corporation GAAP Financial Statements.

* Furnished Herewith