

SILICOM LTD.  
Form 20-F  
March 21, 2013

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UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
WASHINGTON, D.C. 20549

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FORM 20-F

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

Or

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

For the fiscal year ended December 31, 2012

Or

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

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.....

For the transition period from                      to

Commission File number: 000-23288

SILICOM LTD.  
(Exact name of Registrant as specified in its charter and as translated into English)

ISRAEL  
(Jurisdiction of incorporation  
or organization)

8 Hanagar Street,  
Kfar Sava 4442537, Israel  
(Address of principal executive offices)

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

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None	None
Title of each class	Name of each exchange on which registered
Ordinary Shares, NIS 0.01 nominal value per share	NASDAQ GLOBAL MARKET

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

None

(Title of Class)

Securities for which there is a reporting obligation pursuant to Section 15(d) of the Act:

None

(Title of Class)

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

7,007,426

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

Yes  No

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  No

Note—Checking the box above will not relieve any registrant required to file reports pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934 from their obligations under those Sections.

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  No

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  Accelerated filer  Non-accelerated filer

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

US GAAP  International Financial Reporting Standards as issued by the International Accounting Standards Board  Other

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

Item 17  Item 18

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  No

(APPLICABLE ONLY TO ISSUERS INVOLVED IN BANKRUPTCY PROCEEDINGS DURING THE PAST FIVE YEARS)

Indicate by check mark whether the registrant has filed all documents and reports required to be filed by Sections 12, 13 or 15(d) of the Securities Exchange Act of 1934 subsequent to the distribution of securities under a plan confirmed by a court.

Yes  No

This annual report on Form 20-F includes certain “forward-looking” statements within the meaning of Section 21E of the Securities Exchange Act of 1934. The use of the words “projects,” “expects,” “may,” “plans” or “intends”, or words of similar import, identifies a statement as “forward-looking.” There can be no assurance, however, that actual results will not differ materially from our expectations or projections. Factors that could cause actual results to differ from our expectations or projections include the risks and uncertainties relating to our business described in this report at Item 3 titled “Risk Factors.”

As used herein or any in any document incorporated by reference hereto, the “Company”, “Silicom Ltd.”, “Silicom”, “Registrant”, “we”, “us”, or “our” refers to Silicom Ltd. and its subsidiary. We have prepared our consolidated financial statements in United States dollars and in accordance with accounting principles generally accepted in the United States. All references herein to “dollars” or “\$” are to United States dollars, and all references to “Shekels” or “NIS” are to New Israeli Shekels.

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## Part I.

## Item 1. IDENTITY OF DIRECTORS, SENIOR MANAGEMENT AND ADVISERS

Not Applicable.

## Item 2. OFFER STATISTICS AND EXPECTED TIMETABLE

Not Applicable.

## Item 3. KEY INFORMATION

## A. Selected Financial Data

The selected data presented below under the captions “Consolidated Statements of Operations Data” and “Consolidated Balance Sheets Data” for and as of the end of each of the years in the five-year period ended December 31, 2012, are derived from our audited consolidated financial statements. The consolidated financial statements as of December 31, 2011 and 2012, and for each of the years in the three-year period ended December 31, 2012, and the report thereon, are included elsewhere in this annual report. The selected data set forth below should be read in conjunction with our consolidated financial statements and the notes thereto, which are set forth in Item 18 – “Financial Statements” and the other financial information appearing elsewhere in this annual report.

## CONSOLIDATED STATEMENTS OF OPERATIONS DATA:

	Year Ended December 31				
	In US\$ Thousands				
	2008	2009	2010	2011	2012
Sales	\$ 25,554	\$ 20,526	\$ 30,399	\$ 39,633	48,729
Cost of sales	15,405	12,461	17,490	22,430	28,849
Gross profit	10,149	8,065	12,909	17,203	19,880
Research and development costs	3,048	2,716	3,280	4,165	4,401
Sales and marketing expenses	2,093	1,821	2,207	2,677	3,081
General and administrative expenses	1,427	1,313	1,523	1,890	2,369
Total operating expenses	6,568	5,850	7,010	8,732	9,851
Operating income	3,581	2,215	5,899	8,471	10,029
Financial income, net	1,188	909	617	439	752
Income before income taxes	4,769	3,124	6,516	8,910	10,781
Income tax expenses	124	305	801	667	910
Net income(1)	4,645	2,819	5,715	8,243	9,871
Income per share					
Basic income per ordinary share	\$ 0.695	\$ 0.420	\$ 0.838	\$ 1.195	\$ 1.424
Diluted income per ordinary share	\$ 0.685	\$ 0.412	\$ 0.824	\$ 1.178	\$ 1.417
Weighted average number of ordinary shares used to compute basic income per share (in thousands)					
	6,685	6,720	6,821	6,896	6,934
Weighted average number of ordinary shares used to compute					
	6,780	6,843	6,938	6,995	6,968

diluted income per share (in  
thousands)

(1) Net income is after deduction of taxes on income, which have been reduced by virtue of tax benefits to which the Company is entitled in its capacity as a “Benefited Enterprise” under Israeli law. As such, the Company was required to pay taxes at a reduced effective rate. The Company selected the 2004 tax year, the 2006 tax year, the 2009 tax year and the 2012 tax year as its Year of Election, from which the period of benefits under the Investment Law are to commence. See Note 12C to the Financial Statements and “Item 10” - Additional Information - Taxation.”

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## CONSOLIDATED BALANCE SHEET DATA

	2008	2009	2010	2011	2012
Total assets	\$51,974	\$55,591	\$63,479	\$72,865	\$89,033
Total current liabilities	\$4,735	\$4,399	\$5,827	\$6,438	\$11,789
Long-term liability	\$1,905	\$1,967	\$2,222	\$2,153	\$2,278
Shareholders' equity	\$45,334	\$49,225	\$55,430	\$64,274	\$74,966
Capital stock	\$20	\$20	\$20	\$20	\$21
Number of ordinary shares issued (1)	6,709,034	6,824,284	6,894,659	6,940,059	7,022,397

(1) Including 14,971 held by our subsidiary. Under the Israeli Companies Law these shares held by our subsidiary are non-voting shares.

The table below sets forth the high and low NIS to U.S. Dollar exchange rates for each period, as published by the Bank of Israel

	HIGH	LOW
February 2013	3.733	3.663
January 2013	3.791	3.714
December 2012	3.835	3.726
November 2012	3.952	3.810
October 2012	3.912	3.792
September 2012	4.029	3.887

The table below sets forth, for the five most recent full financial years, the average NIS to U.S. Dollar exchange rates for each period, calculated by using the average of the official Bank of Israel representative exchange rate for the last day of each month during the period:

2012	3.844
2011	3.582
2010	3.732
2009	3.927
2008	3.568

The NIS to U.S. Dollar exchange rate on February 28, 2013, as published by the Bank of Israel, was NIS 3.708.

#### Dividends

We have not paid dividends in the past. On January 14, 2013, we announced that our Board of Directors has adopted a policy for distributing dividends, subject to all applicable laws. According to this policy, each year we will distribute a dividend of up to 50% of our annual distributable profits. As part of the stated policy, the Company's Board of Directors reserves the right to declare additional dividend distributions, to change the rate of dividend distributions (either as a policy or on a one-time basis), to cancel a specific distribution or to cancel the policy as a whole at any time, at its sole discretion. The actual distribution of a dividend will be subject to meeting the conditions required by applicable law, including the distribution tests set forth in Section 302 of the Israeli Companies Law - 1999, and to the specific decision of the Company's Board of Directors for each distribution. Future dividend policy will be reviewed by the Board of Directors based upon conditions then existing, including our earnings, financial condition, capital requirements and other factors. Our ability to pay cash dividends may be restricted by instruments governing any of our obligations.

Dividends paid by an Israeli resident company to non-Israeli shareholders are generally subject to withholding tax in Israel at a rate of up to 25%, but the actual withholding rate may be lower or higher than 25% depending upon the type of shareholder. In our case, the applicable withholding tax rate will also depend on the particular Israeli production facilities that have generated the earnings that are the source of the specific dividend and, accordingly, the applicable withholding rate may change from time to time. For more information on the taxation of dividends see the section entitled "Taxation of Dividends" in Section 10.E "Taxation".

On March 18, 2013 our Board of Directors declared a dividend of US \$0.55 per share payable on April 17, 2013 to shareholders of record as of April 4, 2013, and in the aggregate amount of approximately US \$3.9 million for 2012. Taxes will be withheld at source by the Company as required pursuant to Israeli law.

Holders of our ordinary shares should consult their own tax advisors as to the United States, Israeli or other tax consequences of the receipt of any dividend distributions made to our shareholders, including, in particular, the effect of any foreign, state or local taxes, and of any taxes withheld at source by the Company.

B. Capitalization and indebtedness

Not Applicable

C. Reason for the offer and use of proceeds

Not Applicable

D. Risk Factors

This annual report and statements that we may make from time to time may contain forward-looking information. There can be no assurance that actual results will not differ materially from our expectations, statements or projections. Factors that could cause actual results to differ from our expectations, statements or projections include the risks and uncertainties relating to our business described below.

We depend on one line of products for most of our revenues.

Our current business is based to a great extent on our Multi-Port Gigabit-Ethernet Server Adapter product line and the majority of our revenue is generated from such product line. We expect that in the foreseeable future we will continue to be dependent on this line of products for most of our revenue due the nature of our business. We cannot assure you that revenue generated from our Multi-Port Gigabit-Ethernet Server Adapters will reach or exceed historical levels in any future period. A decrease in the price of, or demand for, any of these products, or a significant increase in our costs of manufacturing could have a material adverse effect on our business, results of operations and financial condition.

Increased demand for products with characteristics similar to our products may cause manufacturers to integrate such characteristics into server motherboards, eliminating the need for our add-on products.

Our main products are add-on adapters that are added to existing servers in order to improve their functionality. If demand for such improved functionality increases significantly, server manufacturers may begin incorporating such functionality as a part of the basic design of their servers, thereby eliminating the need to achieve such functionality through add-on adapters. In the past we suffered from a similar trend with respect to our legacy products. We cannot assure you that a similar trend will not occur in connection with our add-on adapters. Such a trend would have a material adverse effect on our business, results of operations and financial condition.

Significant growth in markets demanding functionality similar to the functionality offered by our products may increase the market share of appliances that already have such functionality in-built, eliminating the need for our add-on products.

Our main products are add-on adapters that are added to existing servers in order to improve their functionality. If the demand for functionality similar to the functionality of our add-on adapters continues to grow significantly, the market share of special purpose appliances that already have such functionality in-built may increase, consequently reducing the market share of solutions based on servers with add-on adapters. A reduction in the market share of solutions based on servers with add-on adapters, could, in turn, reduce the demand for our add-on adapters. We cannot assure you that such a trend will not occur. Such a trend would have a material adverse effect on our business, results of operations and financial condition.

We may experience difficulty in developing solutions for appliances with proprietary interfaces which may be used by some of our potential customers.

The market for networking appliances includes appliances that make use of proprietary interfaces. These appliances are offered to our potential customers in addition to the customary server-based appliances which use standard interfaces. Our potential customers may decide to use appliances with proprietary interfaces instead of the customary server-based appliances for which several manufacturers may provide add-on cards. There could be no assurance that we would be able to develop non-standard add-on cards for appliances with proprietary interfaces or, if we are successful in developing such cards, that manufacturers of the proprietary interfaces or the customers electing to use these interfaces will make use of our cards in such non-standard environments.

Our Multi-Port Gigabit-Ethernet Server Networking Adapters including our Bypass Adapters which are sold mainly to OEMs, are characterized by long sales cycles.

We sell our Multi-Port Gigabit-Ethernet Server Networking Adapters (including our Bypass Adapters) mainly to original equipment manufacturers, or OEMs. The decision making process of our OEM customers includes several time consuming processes, resulting from the critical importance of our products in their systems. They need to define the required configuration of their server system/appliance, derive the need and type of adapters, evaluate adapters, intensively test and qualify adapters and then (or in parallel) negotiate the terms for a purchase. It may therefore take 12 months or more from the time we first contact a prospective customer before such customer implements our cards in its system constituting what is known as a Design Win. Additionally, once a Design Win is secured, our sales of these products typically involve significant capital investment decisions by prospective end customers, as well as a significant amount of time to educate such end customers as to the benefits of systems and appliances that include our products. As a result, before purchasing systems and appliances which include our products (and consequently facilitating sales of our products), companies spend a substantial amount of time performing internal reviews and obtaining capital expenditure approvals, consequently lengthening the period of time required for a Design Win to mature into consistent sales. These long sales cycles make it difficult to predict when and to what extent discussions with potential customers will materialize into sales and could cause our revenue and operating results to fluctuate widely from period to period. In addition, our allocation of significant resources to potential sales opportunities that do not materialize into sales could have a material adverse effect on our business, results of operations and financial condition.

The short lead time of customer orders combined with the long lead time of our suppliers when ordering certain components for our products could result in either a surplus or lack of sufficient supplies, and impact negatively on our finances.

While we are generally required to fill orders for our products within one or two weeks following the receipt of a firm purchase order, we must place orders of certain components for our products between sixteen and twenty weeks prior to delivery. As a result, we must have a significant amount of components in our inventory to be able to meet our best forecasts of projected purchase orders as opposed to on the basis of firm purchase orders. In the event that firm purchase orders are significantly lower than such forecasts, a significant part of our inventory will not be used and we may be unable to adjust costs in a timely manner to compensate for revenue shortfalls and in the event that firm purchase orders exceed such forecasts, we will not be able to fill such purchase orders which may lead to the loss of business from a customer.

Our ability to accurately forecast future sales is severely limited due to the short lead time of customer orders.

As a result of the short lead time for firm purchase orders, we are unable to accurately forecast future revenues from product sales. As a result, even dramatic fluctuation in revenue (whether increase or decrease) might not be detected until the very end of a financial quarter, which may not enable us to monitor costs in a timely manner to compensate for such fluctuation.

The loss or ineffectiveness of any of our original equipment manufacturer relationships or a reduction of purchase orders or sales efforts by such original equipment manufacturers may have a material adverse effect on our operations and financial results.

Our sales and marketing strategy is to develop and maintain strategic relationships with leading original equipment manufacturers ("OEMs") in the servers industry and server-based systems industry, which integrate our products into their systems. These OEMs are not within our control, are not obligated to purchase our products, and may select other products that may compete with our lines of products. A reduction in their sales efforts or discontinuance of sales of our products by our OEMs could lead to reduced sales and could materially adversely affect our operating results. Use of OEMs also entails the risk that they will build up inventories in anticipation of a growth in sales. If such growth does not occur as anticipated, such OEMs may substantially decrease the amount of products ordered in subsequent quarters or discontinue product orders. The termination or loss of either one of our key OEM relationships or several OEM relationships at approximately the same time, without being able to compensate this loss with sales to other OEM customers might have a material adverse effect on our operations and financial results.

Our OEM customers may replace the appliances they currently use with appliances that do not require our cards or incorporate cards other than ours.

Many of the OEMs that use appliances which include our cards do so for a few years, and then consider migration to newer generations of appliances. We cannot guarantee that our cards will be needed or selected for such new appliances or compatible with them. A decision by a current OEM customer or customers to select a new appliance without including our cards in such new appliance may have a significant adverse effect on our results of operations.

The loss of a significant customer may have a material adverse effect on us.

We depend on a small amount of customers for our products. Our top two customers accounted for approximately 40% of our revenues in 2012. We expect that a small number of customers will continue to account for a significant portion of our revenues for the foreseeable future. Loss or cancellation of business from, significant changes in deliveries to, or decreases in the prices of services sold to, one or more of our key customers has, in the past, significantly reduced our revenues for a reporting period and could, in the future, harm our margins, financial condition and business.



The markets for our products change rapidly and demand for new products is difficult to predict.

The markets for our products are characterized by rapidly changing technology and evolving industry standards. For example, the migration to 10Gbps solutions, the European Union's directive regarding Restriction Of Hazardous Substances (ROHS) which requires products to be ROHS compliant, the Chinese ROHS directive and the migration from the PCI-X server bus to the PCI-Express (PCI-E) server bus, cause our OEM customers to demand such new products and technologies. In the event that our OEM customers decide to begin using such new technologies, we may not be able to develop products for the new technologies in a timely manner. Our OEM customers may also select competing products despite our ability to develop products incorporating new technologies. Furthermore, the migration to 10Gbps, while presenting an opportunity for more cards and solutions to be sold, may also result in a decrease in the need for Multi-Port cards as throughput performance may be achieved via a single port of 10Gbps. Consequently, we may suffer from reduced sales to such OEMs and accumulate unusable inventory which can be used only with older technologies. We intend to continue investing in product and technology development. Although we have recorded growing sales of our line of products (to which the majority of our revenues are attributable), there can be no assurance that we will continue to be successful in the marketing of our current products and in developing, manufacturing and marketing enhanced and new products in a timely manner.

We may experience difficulty in developing new, commercially successful products at acceptable release times.

We conduct extensive research, development and engineering activities. Our efforts emphasize the development of new products, cost reduction of current products, and the enhancement of existing products, generally in response to rapidly changing customer preferences, technologies and industry standards. We cannot guarantee the continued success of our latest lines of products, Multi-Port Gigabit-Ethernet Server Networking Adapters and Bypass Adapters, that they will be widely accepted by the marketplace or that any of our development efforts will result in commercially successful products, that such products will be released in a timely manner or that we will be able to respond effectively to technological changes or new product announcements by others.

Loss of our sources for certain key components could harm our operations.

Although we generally use standard parts and components for our products, certain key components used in our products are currently available from only one source, and others are available from a limited number of sources. We believe that we maintain a sufficient inventory of these components to protect against delays in deliveries. However, we cannot guarantee that we will not experience delays in the supply of critical components in the future or that we will have a sufficient inventory of critical components at such time to produce products at full capacity. Additionally, a key component in many of our cards is manufactured by Intel, one of our competitors. While we have not encountered difficulties in purchasing such components from Intel's distributors, we cannot guarantee that we will continue to be able to purchase such components without delays or at reasonable prices. In the event that we are not able to purchase key components of our products from our limited sources, or are able to purchase these key components only under unreasonable terms, we may need to redesign certain products. We cannot guarantee that we will have adequate resources for such a redesign or that such a redesign will be successful. Such inability to obtain alternative resources or to successfully redesign our products could have a material adverse effect on our business, results of operations and financial condition.

Inability to receive information from our key component manufacturers could affect our ability to develop new products required by our OEM customers and by the industry in which we operate.

Our products are based on networking controllers which are manufactured by either Broadcom, Cavium or Intel. In order to design our products we need to receive information that enables us to design products with the use of such controllers. There can be no assurance that we will continue to receive all the information required for designing products with the use of new controllers continuously released by the above mentioned companies. Intel and Cavium are our competitors and Broadcom may also compete with our products. Such competition may also affect their decisions regarding the sharing of information with us. The inability to obtain such information may adversely affect our ability to develop new products required by our OEM customers and by the industry in which we operate.

We may need to invest significantly in research and development and business development in order to diversify our product offering and enter new markets.

Most of our revenues are generated from the sale of our add-on Server Adapters. The technology industry in which we operate is characterized by rapid technological change, frequent new product introductions, changes in customer requirements and evolving industry standards. While these changes could lead to a reduction in the demand for our existing products, they could also create an opportunity for us to expand our product offering to our existing customers and to new customers. Accordingly, our future success may depend on our ability to diversify our product offering and enter new markets, which could involve numerous risks, including:

- Substantial research and development and business development expenditures, which could divert funds from other corporate uses and/or have a significant negative effect on our short-term results;
- Diversion of management's attention from our core business; and
- Entering markets in which we have little or no experience.

There can be no assurance that we will be able to successfully complete the development and market introduction of new products and no assurance that we will be able to successfully enter new markets. This could have a material adverse effect on our business, results of operations and financial condition.

We may make acquisitions or pursue mergers that could disrupt our business and harm our financial condition.

As part of our business strategy, we may seek to invest in or acquire other businesses, technologies or assets, or we may enter into joint ventures or other strategic relationships with third parties.

We may assume liabilities, incur amortization expenses related to intangible assets or realize large and immediate write-offs in connection with future acquisitions. In addition, the future valuation of these acquisitions may decrease from the market price paid by us, which may result in the writing-off, or impairment, of the relevant assets. In addition, our operation of any acquired or merged businesses, technologies or assets could involve numerous risks, including:

- Post-merger integration problems resulting from the combination of any acquired operations with our own operations or from the combination of two or more operations into a new merged entity;
  - Diversion of management's attention from our core business;
  - Substantial expenditures, which could divert funds from other corporate uses;
  - Entering markets in which we have little or no experience; and
  - Loss of key employees of the acquired operations.

We cannot be certain that any future acquisition or merger will be successful. If the operation of the business of any future acquisition or merger disrupts our operations, our business may suffer. In addition, even if we successfully integrate the acquired business with our own, we may not receive the intended benefits of the acquisition.

The market for our products is highly competitive and some of our competitors may be better positioned than we are.

The market for our products is highly competitive. We face competition from numerous companies, some of which are more established, benefit from greater market recognition and have greater financial, production and marketing resources than we do. For example, in the server networking industry for which we have developed our Multi-Port Gigabit-Ethernet Server Networking cards, our main competitor is Intel. We cannot guarantee that our present or contemplated products will continue to be distinguishable from those of our competitors or that the marketplace will find our products preferable to those of our competitors. Furthermore, there can be no assurance that competitive pressures will not result in price reductions that could materially adversely affect our business and financial condition and the results of our operations.

We may not be able to prevent others from claiming that we have infringed their proprietary rights.

We cannot guarantee that one or more parties will not assert infringement claims against us. The cost of responding to claims could be significant, regardless of whether the claims have merit. Significant and protracted litigation may be necessary to determine the scope of the proprietary rights of others or to defend against claims of infringement, regardless of whether the claims have merit. Although we believe that all our products use only our intellectual property, or intellectual property which is properly licensed to us, in the event that any infringement claim is brought against us and infringement is proven, we could be required to discontinue the use of the relevant technology, to cease the manufacture, use and sale of infringing products, to incur significant litigation damages, costs and expenses, to develop non-infringing technology or to obtain licenses to the alleged infringing technology and to pay royalties to use such licenses. There can be no assurance that we would be able to develop any such alternative technologies or obtain any such licenses on terms commercially acceptable to us.

On March 2, 2012 Internet Machines LLC, a Texas limited liability company filed a patent infringement lawsuit in the United States District Court for the Eastern District of Texas (the "Court") against numerous defendants (including many switch manufacturers) with respect to certain patents for switches, and included our US subsidiary amongst the list of defendants named in such lawsuit. The lawsuit claims that the defendants have infringed certain patents purported to be owned by Internet Machines LLC and seeks unspecified compensation for damages as well as injunctive relief. The defendants filed answers and counterclaims to the complaint asserting that they do not infringe any claims of the asserted patents and the claims of the patents are invalid and/or unenforceable. While one of our switch suppliers (which is also named as a defendant in the aforesaid lawsuit) has agreed to indemnify us with respect to certain liabilities, there is no certainty that we will ultimately be able to collect all or any amounts under such indemnity should we be found liable under the lawsuit. On September 4, 2012, the Court granted the defendants' motion to stay the pending litigation. We are unable at this time to assess the likelihood of an unfavorable outcome or range of potential loss.

Although in the past we have resolved a claim of infringement through a license agreement, the terms of which did not have a material effect on our business, any infringement claim or other litigation against us, including a successful pursuit of the aforesaid claim recently filed against our US subsidiary, could seriously harm our business, operating results and financial condition. While there are no other lawsuits or other claims currently pending against us regarding the infringement of patents or intellectual property rights of others, we have been a party to such claims in the past and may be party to such claims in the future.

We may not be able to protect our intellectual proprietary rights.

Our success, ability to compete, and future revenue growth are dependent will depend, in part, on our ability to protect our intellectual property. It is possible that competitors or other unauthorized third parties may obtain, copy, use or disclose our technologies and processes. Any of our existing or future patents may be challenged, invalidated or circumvented. If our intellectual property rights do not adequately protect our technology, our competitors may be able to offer products similar to ours.

In order to establish and protect the technology we use in our products, we primarily rely on a combination of non-disclosure agreements and technical measures, and to a lesser degree on patents. We enter into confidentiality agreements with our employees, consultants and other third parties with whom we conduct business. In addition, our employees involved in the development of our technologies are required to sign non-compete and invention assignment agreements. We also control access to and distribution of our technologies, documentation and other proprietary information. Despite these efforts, internal or external parties may attempt to copy, disclose, obtain or use our products, services or technology without our authorization.

We believe that these measures afford only limited protection, and accordingly, there can be no assurance that the steps we take will be adequate to prevent misappropriation of our technology or the independent development of similar technologies by others. The process of seeking patent protection may take a long time and be expensive. We cannot assure you that patents will be issued from pending or future applications or that, if patents are issued, they will not be challenged, invalidated or circumvented or that the rights granted under the patents will provide us with meaningful protection or any commercial advantage. In addition, we cannot assure you that other countries in which we market our services and products will protect our intellectual property rights to the same extent as the United States. Effective intellectual property enforcement may be unavailable or limited in some countries. It may be difficult for us to protect our intellectual property from misuse or infringement by other companies in these countries. Our inability to enforce our intellectual property rights in some countries may harm our business and results of operations. Litigation, which could result in substantial costs to us and diversion of our resources, may also be necessary to enforce our patents or other intellectual property rights. Further, we cannot assure you that we will at all times enforce our patents or other intellectual property rights or that courts will uphold our intellectual property rights, or enforce the contractual arrangements that we have entered into to protect our proprietary technology, which could reduce our opportunities to generate revenues. Our confidentiality and non-competition agreements may not be enforceable and our proprietary technology may not remain a secret. Others may develop similar technology and use this technology to compete with us. Despite our efforts to protect our proprietary rights, former employees and other unauthorized parties may attempt to copy aspects of our products or obtain and use information that we regard as proprietary.

We are dependent on key personnel.

Our success has been, and will be, dependent to a large degree on our ability to retain the services of key personnel and to attract additional qualified personnel in the future. Competition for such personnel is intense. There can be no assurance that we will be able to attract, assimilate or retain key personnel in the future and our failure to do so would have a material adverse effect on our business, financial condition and results of operations.

Exchange rate fluctuations and international risks could increase the cost of our operations.

Substantially all of our international sales are denominated in U.S. dollars and may be subject to government controls and other risks, including, in some cases, export licenses, federal restrictions on export, currency fluctuations, political instability, trade restrictions, and changes in tariffs and freight rates. Our dollar costs in Israel will increase further to the extent that inflation in Israel exceeds the devaluation of the NIS against the dollar, if the timing of such devaluation lags behind inflation in Israel or if the dollar devalues against the NIS.

If we are characterized as a passive foreign investment company for U.S. federal income tax purposes, our U.S. shareholders may suffer adverse tax consequences.

We will be a passive foreign investment company, or PFIC, if 75% or more of our gross income in a taxable year, including our pro-rata share of the gross income of any company, U.S. or foreign, in which we are considered to own, directly or indirectly, 25% or more of the shares by value, is passive income. Alternatively, we will be considered to be a PFIC if at least 50% of our assets in a taxable year, averaged over the year and ordinarily determined based on fair market value and including our pro-rata share of the assets of any company in which we are considered to own, directly or indirectly, 25% or more of the shares by value, are held for the production of, or produce, passive income. If we were to be a PFIC, and a U.S. Holder does not make an election to treat us as a "qualified electing fund," or QEF, or a "mark-to-market" election, "excess distributions" to a U.S. Holder, and any gain recognized by a U.S. Holder on a disposition of our ordinary shares, would be taxed in an unfavorable way. Among other consequences, our dividends, to the extent that they constituted excess distributions, would be taxed at the regular rates applicable to ordinary income, rather than the 15% maximum rate applicable to certain dividends received by an individual from a qualified foreign corporation, and certain "interest" charges may apply. In addition, gains on the sale of our shares would be treated in the same way as excess distributions. The tests for determining PFIC status are applied annually and it is difficult to make accurate predictions of future income and assets, which are relevant to the determination of PFIC status. In addition, under the applicable statutory and regulatory provisions, it is unclear whether we would be permitted to use a gross loss from sales (sales less cost of goods sold) to offset our passive income in the calculation of gross income. As a result of our substantial cash position, if the value of our shares declines, there is a substantial risk that we will be classified as a PFIC under the asset test described above. There can be no assurance that we will not be classified as a PFIC by the U.S. Internal Revenue Service. In light of the uncertainties described above, no assurance can be given that we will not be a PFIC in any year. A U.S. Holder who makes a QEF election is taxed currently on such holder's proportionate share of our earnings. If the IRS determines that we are a PFIC for a year with respect to which we have determined that we were not a PFIC, however, it might be too late for a U.S. Holder to make a timely QEF election, unless the U.S. Holder qualifies under the applicable Treasury regulations to make a retroactive (late) election. U.S. Holders who hold ordinary shares during a period when we are a PFIC will be subject to the foregoing rules, even if we cease to be a PFIC, subject to exceptions for U.S. Holders who made a timely QEF or mark-to-market election, or certain other elections. We do not currently intend to prepare or provide the information that would enable you to make a Qualified Election Fund election. Accordingly, our shareholders are urged to consult their tax advisors regarding the application of PFIC rules.



The tax benefits available to us under Israeli law require us to meet several conditions and applying plan administration rules, and may be terminated or reduced in the future, which would increase our taxes.

Our production facilities have been granted "Benefited Enterprise" status and since and as such, we are entitled to certain tax benefits. To be eligible for these tax benefits, we must meet conditions and applying plan administration rules. If we fail to meet these conditions in the future, the tax benefits would be canceled and we could be required to refund any tax benefits we might already have received. These tax benefits may not be continued in the future at their current levels, or at any level. In recent years, the Israeli government has reduced the benefits available and has indicated that it may further reduce or eliminate some of these benefits in the future. The termination or reduction of these benefits may increase our income tax expense in the future. To the best of our knowledge, to date we have met the conditions for benefits under our "Benefited Enterprise" program in all material respects. There can be no assurance, however, that we will continue to meet such conditions in the future. See Item 10 "Additional Information – Taxation – Law for the Encouragement of Capital Investments, 1959" for more information about our "Benefited Enterprise" status.

The trading volume of our shares has been low in the past and may be low in the future, resulting in lower than expected market prices for our shares.

Our shares have been traded at low volumes in the past and may be traded at low volumes in the future for reasons related or unrelated to our performance. This low trading volume may result in lower than expected market prices for our ordinary shares and our shareholders may not be able to resell their shares for more than they paid for them.

Israeli courts might not enforce judgments rendered outside of Israel.

We are incorporated in Israel. All of our executive officers and all of our directors are non-residents of the United States, and a substantial portion of our assets and the assets of these persons are located outside the United States. Therefore, it may be difficult to enforce a judgment obtained in the United States against us or any such persons. It may also be difficult to enforce civil liabilities under U.S. federal securities laws in original actions instituted in Israel. However, subject to certain time limitations, Israeli courts may enforce U.S. final executory judgments for liquidated amounts in civil matters obtained after due trial before a court of competent jurisdiction (according to the rules of private international law currently prevailing in Israel) which enforces similar Israeli judgments, provided that the requisite procedural and legal requirements are adhered to. If a foreign judgment is enforced by an Israeli court, it generally will be payable in NIS, which can then be converted into foreign currency at the rate of exchange of such foreign currency on the date of payment. Pending collection, the amount of the judgment of an Israeli court stated in NIS (without any linkage to a foreign currency) ordinarily will be linked to the Israeli consumer price index plus interest at the annual statutory rate prevailing at such time. Judgment creditors bear the risk of unfavorable exchange rates.



The political environment and hostilities in Israel could harm our business.

Since the establishment of the State of Israel in 1948, a state of hostility has existed between Israel and the Arab countries in the region. This state of hostility has varied in degree and intensity over time. There has also been conflict and unrest between Israel, the Palestinian Authority and certain terrorist groups operating within the Palestinian Authority and Lebanon. A significant increase in violence began in September 2000 and has continued with varying levels of severity through 2012, the most severe of which was Israel's war with the Hizbullah militant group in July and August of 2006. In December 2008 and January 2009 there was an escalation in violence among Israel, Hamas, the Palestinian Authority and other groups, as well as extensive hostilities along Israel's border with the Gaza Strip, which resulted in missiles being fired from the Gaza Strip into Southern Israel. Similar hostilities accompanied by missiles being fired from the Gaza Strip into Southern Israel, as well at areas more centrally located near Tel Aviv and at areas surrounding Jerusalem, occurred during November 2012. Since February 2011, Egypt has experienced political turbulence and an increase in terrorist activity in the Sinai peninsula, following the resignation of Hosni Mubarak as president, including protests throughout Egypt, and the appointment of a military regime in his stead, followed by the elections to parliament which brought groups affiliated with the Muslim Brotherhood (which had been previously outlawed by Egypt) which may damage the current peaceful and diplomatic relations between Israel and Egypt, and which could affect the region as a whole. Similar civil unrest and political turbulence has occurred in other countries in the region, including Syria which shares a common border with Israel, and is affecting the political stability of those countries. This instability may lead to deterioration of the political and economic relationships that exist between the State of Israel and some of these countries. In addition, Iran has threatened to attack Israel and is widely believed to be developing nuclear weapons. Iran is also believed to have a strong influence among extremist groups in the region, such as Hamas in Gaza, Hezbollah in Lebanon, and various rebel militia groups in Syria. These situations may potentially escalate in the future to more violent events which may affect Israel and us. Furthermore, several countries still restrict trade with Israeli companies and additional countries may impose such restrictions as a result of changes in the military and/or political conditions in Israel and/or the surrounding countries, which may limit our ability to make sales in, or purchase components from, those countries. Any future armed conflict, political instability, continued violence in the region or restrictions could have a material adverse effect on our business, operating results and financial condition. While such hostilities did not in the past have a material adverse impact on our business, we cannot guarantee that hostilities will not be renewed and have such an effect in the future. The political and security situation in Israel may result in parties with whom we have contracts claiming that they are not obligated to perform their commitments under those agreements pursuant to force majeure provisions. Any hostilities involving Israel or the interruption or curtailment of trade between Israel and its present trading partners could adversely affect our operations and could make it more difficult for us to raise capital. Since many of our facilities are located in Israel, we could experience serious disruptions if acts associated with this conflict result in any serious damage to our facilities. Our business interruption insurance may not adequately compensate us for losses that may occur and any losses or damages incurred by us could have a material adverse effect on our business. Any future armed conflicts or political instability in the region would likely negatively affect business conditions and harm our results of operations.

Many of our employees in Israel are required to perform military reserve duty.

All non-exempt male adult citizens and permanent residents of Israel under the age of 40, or older for reserves officers or citizens with certain occupations, as well as certain female adult citizens and permanent residents of Israel, are obligated to perform military reserve duty and may be called to active duty under emergency circumstances. In recent years, there have been significant call-ups of military reservists, and it is possible that there will be additional call-ups in the future. While we have operated effectively despite these conditions in the past, we cannot assess what impact these conditions may have in the future, particularly if emergency circumstances arise. Our operations could be disrupted by the absence for a significant period of one or more of our executive officers or key employees or a significant number of our other employees due to military service. Any disruption in our operations would harm our business.

We are affected by volatility in the securities markets.

The securities markets in general have experienced volatility which has particularly affected the securities of many high-technology companies and particularly those in the fields of communications, software and internet, including companies that have a significant presence in Israel. This volatility has often been unrelated to the operating performance of these companies and may cause difficulties in raising additional financing required to effectively operate and develop their businesses. Such difficulties and the volatility of the securities markets in general may affect our financial condition and results.

We are affected by worldwide downturns in industries based on technology.

The volatility in the securities markets discussed above and its effect on high-technology companies may have a ripple effect on our performance. In the downturn which the markets experienced beginning in 2001, technology companies dealing in communications and computers were severely affected and some were forced to cease operations. We felt the effects of this downturn in 2001 through 2003. Currently, we are affected by the downturn in the economic markets which began in 2008, posing a risk to industries based on technology as well as the overall economy. We can give no assurance that our results will not be affected on a going forward basis by the current downturn and by any future downturns.

General economic conditions may adversely affect the Company's results.

Current uncertainty in global economic conditions, including the recent disruption in financial and credit markets, pose a risk to the overall economy that could impact demand for our and our customers' products, as well as our ability to manage commercial relationships with our customers, suppliers and creditors. If the current situation continues or worsens, our business could be negatively impacted, including such areas as reduced demand for our products and services, or supplier or customer disruptions, which could reduce our revenues or our ability to collect our accounts receivable and have a material adverse effect on our financial condition and results of operations.

We may experience a further decline in our share price and there is no guarantee that our share price will rise at all.

Our share price fell during the recent period of uncertainty in global economic conditions and we expect it to continue to be affected by such uncertainty to the extent that it continues. We cannot assure you that our share price will stabilize, or not decline, in the coming fiscal year.

We may not be able to fulfill our dividend policy in the future.

We have announced a dividend policy for distributing up to 50% of our annual distributable profits as a dividend, and our Board of Directors recently declared a dividend to be distributed in April 2013. Our ability to distribute dividends in the future may be adversely affected by the risk factors described in this report. As part of the stated dividend policy, the Company's Board of Directors reserves the right to declare additional dividend distributions, to change the rate of dividend distributions (either as a policy or on a one-time basis), to cancel a specific distribution or to cancel the policy as a whole at any time, at its sole discretion. Any dividend will depend on our earnings, capital requirements, financial condition and other business and economic factors affecting us at the time as our board of directors may consider relevant. Our ability to pay cash dividends may be restricted by instruments governing any of our obligations. We may pay dividends in any fiscal year only out of "profits," as defined by the Israeli Companies Law, unless otherwise authorized by an Israeli court, and provided that the distribution is not reasonably expected to impair our ability to fulfill our outstanding and expected obligations. There is no assurance that we will be able to continue paying dividends or increase our payment of dividends in the future, nor is there any assurance that our Board of Directors will not change our dividend policy in the future. If we are unable to fulfill our stated dividend policy, or pay dividends at levels anticipated by investors in our shares, the market price of our shares may be negatively affected and the value of our shareholders' investment may be reduced. See "Item 8.A Consolidated Statements and Other Financial Information", under the caption "8A – Dividend Policy" for additional information regarding the payment of dividends.

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 the Tel Aviv Stock Exchange. Trading in our ordinary shares on these markets takes place in different currencies (dollars on the Nasdaq Global Market and 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 United States and Israel). The trading prices of our ordinary shares on these two markets may differ due to these and other factors. 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.

Our investment portfolio may be impaired by disruptions in the financial and credit markets.

Our investment portfolio currently consists of corporate debt securities and government debt securities, which the Company classified at December 31, 2012 as "held-to-maturity". As of December 31, 2012, we hold approximately US\$ 41 million in corporate debt securities and government debt securities.

Due to recent significant disruptions in the financial and credit markets, corporate debt securities in our portfolio are subject to a possible increased risk of default due to bankruptcy, lack of liquidity, operational failure or other factors affecting the issuers of those securities. In addition, securities in our portfolio are subject to other risks, such as credit, liquidity, market and interest rate risks, which may be exacerbated by the recent market disruptions, and which may impair the assets. We may be required to adjust the carrying value of our investment securities due to a default, lack of liquidity or other event, if the event constitutes an impairment which is considered to be other-than-temporary. As of December 31, 2012, we were not required to adjust the carrying value of our investment securities since there were no other-than-temporary impairments.

This loss would be recorded in our consolidated statement of operations which could materially adversely impact our consolidated results of operations and financial condition.

#### Item 4. INFORMATION ON THE COMPANY.

##### A. History and Development of the Company

Our legal and commercial name is Silicom Ltd. We were incorporated under the laws of Israel in 1987, and we operate under Israeli law and legislation. Our registered and principal executive offices are located in Israel at 8 Hanagar Street, Kfar Sava, Israel 4442537, and our telephone number is +972-(0)9-764-4555. Our website is <http://www.silicom.co.il>. We do not intend for any information contained on our internet website to be considered part of this annual report.

We are currently engaged in the design, manufacture, marketing and support of connectivity solutions for a broad range of servers and server based systems. Our first products were integrated circuits for information technology (or IT) manufacturers. In the early 1990s, we began focusing our strategy on designing, manufacturing, marketing and supporting a range of connectivity solutions for mobile and personal computers users. In subsequent years we developed several broadband internet related products.

In 2002, we leveraged our expertise and know-how in networking and operating systems to develop a line of high-end Multi-Port server networking cards, which in the past had contributed to our sales growth and which we expect to continue being the principal driver of our sales growth in the coming years. In November and December of 2003 we began implementing our “Design Win” business model, as described below in “Item 4. Business Overview”, pursuant to which we began selling our products to customers that incorporate such products within their networking appliances and/or server based systems and sell such systems with our products embedded in them. Since then we have identified the server-based network appliances market and specifically the server-based security appliances and WAN (Wide Area Network) optimization appliances within such market as demonstrating a strong demand for our products. We have added Bypass Adapters, which are networking products that include special functionalities for the server based appliances, to our product lines and received significant orders for both our Bypass Adapters and our non-Bypass adapters. We secured additional Design Wins during 2004-2012, several of which were with leading companies engaged in a number of industries. In 2009, we added to our product lines the new SERVER To Appliance Converter ("SETAC"), which are products that enable us to offer a full network appliance platform solution and address new market segments. In June 2012 we were issued patent No. 8,199,523 entitled ‘Server-Based Network Appliance’ from the United States Patent and Trademark Office with respect to our SETAC product.

On December 20, 2005, we obtained the approval of the Tel Aviv Stock Exchange, or TASE, for the listing of our shares on TASE. Trading of our shares on TASE commenced on December 27, 2005. Our shares are included in the Tel-Tech index. Our shares have been listed on the NASDAQ Global Market (previously known as the NASDAQ National Market) under the ticker symbol “SILC” (previously “SILCF”) since February 11, 2008. Prior thereto, our shares were listed on the NASDAQ Capital Market (previously known as the NASDAQ Small-Cap). See Item 9. “The Offer and Listing - Markets and Share Price History”.

In January 2006, we completed an offering and sale of 10,000 units in Israel, composed of 800,000 of our ordinary shares and 400,000 warrants, pursuant to a prospectus filed with the Israeli Securities Authority and TASE. Each warrant sold in the offering was exercisable into one of our ordinary shares until January 31, 2008 at an exercise price in NIS equivalent to \$8.64 calculated on the date of exercise of such warrant. The sale of units resulted in net proceeds of approximately \$5.6 million. As of January 31, 2008 (i.e. the expiration date of the warrants), 399,934 warrants were exercised, resulting in additional proceeds of approximately \$3.5 million in the aggregate. The offering and sale of the units pursuant to the January 2006 prospectus was made only in Israel and was not intended for the public in the United States or any other country. All purchasers of securities pursuant to the January 2006 prospectus were deemed to have stated that they are not “U.S. Persons” as defined in Regulation S under the Securities Act of 1933, or the Securities Act, that they did not purchase securities for the benefit of any U.S. Person and that they were not present in the United States at the time the request for purchase of the securities was submitted. A similar statement was required from anyone requesting to exercise warrants purchased in the offering. The January 2006 prospectus and the securities offered thereunder are subject to Israeli law. The January 2006 prospectus was not filed with the Securities Exchange Commission and the securities offered thereunder are not registered in accordance with the Securities Act. We have not assumed any obligation to register any of the securities offered under the January 2006 prospectus, in accordance with the Securities Act.

In May 2007, we conducted a private placement, pursuant to which we issued to certain “accredited investors” and “qualified institutional purchasers” 875,000 ordinary shares at a purchase price of \$20.50 per share and warrants to purchase up to 218,750 ordinary shares at an exercise price of \$28.25 per share. We issued to the placement agents warrants to purchase up to an aggregate of 10,937 ordinary shares on the same terms as the warrants issued to the investors. Net proceeds from the private placement were approximately \$16.8 million, net of \$1.2 million of issuance costs. The warrants issued to the investors and to the placement agents expired in July 2010. Prior to their expiration in July 2010, no such warrants were exercised into shares.

#### Principal capital expenditures and divestitures

From January 1, 2012 to December 31, 2012, our capital expenditures totaled approximately \$798 thousand (compared to \$566 thousand during 2011 and \$466 thousand during 2010), of which approximately \$646 thousand (compared to \$460 thousand during 2011 and \$404 thousand during 2010) can be attributed to machinery and equipment, and approximately \$152 thousand (compared to \$104 thousand during 2011 and \$62 thousand during 2010) can be attributed to office furniture and equipment and leasehold improvements.

#### B. Business Overview

We are currently active in the product line of high-end server networking cards with and without bypass (Server Adapters), which is described in greater detail below. For the purpose of these products we leverage our expertise in networking and operating systems and in facilitating improved connectivity for servers by increasing the number of ports on the server adapters and by adding bypass and other special functionality for security appliances, WAN (Wide Area Network) optimization appliances and other network appliances. Commencing in 2006, we extended our product line by adding intelligent and programmable cards, such as encryption acceleration cards and redirector cards. We also added intelligent stand alone bypass units. In 2008, we extended the line of Server Adapters by adding 10Gbps products with and without bypass, with a variety of interfaces. Revenues of our 10Gbps products are currently rising.

Furthermore, in 2009 we introduced our now patented SETAC (Server To Appliance Converter) product family. The SETAC product family is a unique solution that enables standard servers to be configured as network appliances with high-density front networking ports and easy port modularity. We believe that the SETAC products and SETAC-derivative modules have already turned into one of the drivers of our growth, and will continue to be one of our growth drivers in the coming years.

During 2011-2012, we developed the DNA (Direct NIC Access), a specialized plugin-over-PFring used as a zero-copy tool that enables Intel chips to send and receive packets in wire-speed (line rates of 10G or 1G). DNA works by bypassing the Linux kernel, thereby allowing the application to read packets directly from the NIC.

During 2012, we developed the Lib Zero, a library that implements packet sharing in zero-copy. LibZero is able to operate at line rate with any packet size, and implements basic RX/TX capabilities, giving developers a flexible packet processing framework in addition to DNA that is implemented in zero-copy.

During 2012 we developed a Nano-Second Time-Stamping NIC. The NIC combines Intel's networking silicon and the Company's time-stamping FPGA (field programmable gate array), working at wire speed to time-imprint packets.

#### Server Adapters

In an effort to leverage our strengths, in late 2002 we began exploring a new direction which has become our primary growth driver and which we project will continue being our main source of growth in the next few years: high-end server networking cards. Our core expertise has always been our broad range of Ethernet and connectivity products, which provided personal computer users with solutions to their connectivity problems. In late 2002, we decided to employ our core know-how in the realm of server-based systems. Doing so takes advantage of our competitive edge by using the expertise we have developed in connectivity solutions for personal computers in industries which require broader connectivity solutions with very high-performance environments. Examples of these industries are security, WAN optimization, load balancing and other network appliances, data storage, video on demand, internet content delivery, high-performance computing and web servers.

We have developed a line of products for the server networking industry which facilitates interaction between servers, allowing them to communicate with each other through a larger number of ports and with higher performance than their original capabilities. These are powerful products that allow server-based systems to fully exploit the high speed potential of 1/10 Gigabit Ethernet. The products have either one, two, four, six or eight ports, which plug into the servers between which interaction is facilitated. We believe that our products cover a broader scope of features than those of our main competitor, Intel. We believe that our expanded feature set coupled with the fact that our products are based on two different industry leader chip sets (Intel and Broadcom), which makes them more compatible with our potential customers' needs, gives us a competitive edge. To the best of our knowledge we are currently the only company offering such a comprehensive range of server networking products.

Following demands from customers and potential customers, we developed some of these same products with a bypass feature. Intended for mission-critical environments, Silicom's 1/10 Gigabit Ethernet Bypass Networking Cards feature innovative bypass circuitry to maintain continuity of network connectivity in the event of an appliance failure. Upon the occurrence of an appliance failure, the card's bypass mechanism automatically reroutes traffic to bypass faulty components, enabling customers to have reliable and always available network accessibility. As with all of Silicom's 1/10 Multiport Gigabit Ethernet Networking Cards, the Bypass Cards also improve server throughput and performance during normal operations by introducing more ports and better throughput while reducing network congestion, simplifying network management, and minimizing CPU utilization. In addition, we have also developed stand-alone bypass solutions which do not include the networking component. The addition of the innovative bypass capability makes Silicom 1/10 Gigabit Ethernet Bypass Networking Cards and stand-alone bypass solutions an appropriate connectivity solution for security and WAN optimization appliances, as well as for appliances targeted at other high-potential, growing markets such as network monitoring, load balancing, network event management, network optimization, LAN policy enforcement, intrusion detection, virus protection, e-mail content filtering, and more. To the best of our knowledge we are currently the only company offering such a comprehensive line of bypass products, which offers dual port and quad port cards, copper and fiber interfaces and dual chip set (Intel and Broadcom). Although the situation may change in the future, we believe that our competition in the bypass card market is less significant than our competition in the non-bypass card market.

Our Server Adapter products are divided into three groups: Multi-port 1/10 Gigabit Ethernet Server Adapters, innovative internal and external Bypass solutions and advanced Smart Adapters (which include SSL encryption solutions and Redirector Adapters). See "Item 4. Information on the Company – Research and Product Development".

The principal applications of such products, all of which demand high performance Multi-Port connectivity, are as follows:

- Security appliances
- WAN optimization appliances
- Load balancing and traffic management appliances
- Network-attached storage (NAS)
- Video on Demand servers
- Content Delivery servers
- Internet Service Providers / Web Hosting
- High end computing



It would be difficult to design such high-end products without a high level of cross-disciplinary knowledge. The products we have developed use our Ethernet and operating systems expertise. The products in this line include more than one hundred Multi-Port Gigabit Ethernet Server Networking cards (bypass and non-bypass).

Our business model for our Server Adapter line of products is called the Design Win Model. The following are the main aspects of this model:

- We approach a potential customer or are approached by such customer.
- If the customer shows interest in the products and we believe that achievement of a business relationship with the customer is possible, we ship products for such customer's evaluation.
- During the evaluation process the customer receives a few of our Server Networking Cards for initial basic testing. If the evaluation process is successful, we ship products for qualification.
- During the qualification process the customer receives a larger amount of our Server Networking Cards for more specific testing, which may include certain customization of our products to its specific needs.
- If the qualification process is successful, we enter into negotiations regarding the terms of a business relationship.
- In some cases, typically with the larger customers, the evaluation and qualification process may take 12 months or more.
- Once all phases mentioned above are concluded, the customer will purchase products from us, in order to incorporate them within its server based systems and sell such systems with our cards embedded in them. The sale of our products within such systems is the objective of our Design Win Model. In most cases once we secure a Design Win our customer will continue to buy our cards for as long as it continues to sell its server based system. Yet, in some cases, we may only be a second source from which a customer purchases, in which case the customer may not necessarily make continuous orders.

We believe that the high-end server networking cards (with and without bypass) will continue to be a key driver of our growth in the coming years. A distinct advantage of these products is that the demand in the server based industry has been almost continuously growing. Certain fields within this industry, such as the security appliances market, WAN optimization appliances market, other network appliances market, the storage market and several additional markets have demonstrated strong growth. This industry continues to require innovative solutions that must become faster and must provide additional functionalities each time they are implemented. However, achieving Design Wins according to the process described above and obtaining new customers is time consuming as a result of the fact that the sales cycles for products in this industry are long. Nevertheless, each Design Win we achieve may represent an opportunity for sustained, long-term revenues.

### Server To Appliance Converter ("SETAC")

In a continuous effort to leverage our strength in networking solutions, in 2009 we launched our SETAC products, which convert standard servers to network appliances and are designed for systems that require front input/output ("I/O") ports, I/O ports replaceable without opening the system chassis, high quantity of I/O ports and flexibility to provide high quantity of different configurations. This new product line responds to the dilemma currently faced by network appliance providers in designing their network appliances, which is either using a general server with standard add-on adapters, assuring server-grade reliability and a stable state of the art technological environment but sacrificing flexibility, or using specific appliance-oriented hardware solutions, allowing superior flexibility and field re-configurability but lacking in server grade reliability and technological stability. SETAC products offer the benefits of these two options, enabling branded high technology servers to be configured as hardware appliances, and creating an ideal network appliance that combines server grade reliability, front-end access, field-replaceable architecture and a stable, cutting edge technology environment.

The SETAC product line includes SETAC converters (comprised of PCI-Express G2 adapter, cables and Silicom's backplane), which interface with Silicom's front loading I/O Express Modules adapters. SETAC products are installed by a simple process of placing Silicom's I/O Express Modules adapters into a server's "hot-swap" hard drive slots. This combination enables standard servers to be configured as network appliances with server-grade reliability, front-end access, field replaceable architecture and a stable technology environment, creating a complete network appliance platform solution that provides us with a competitive edge. To the best of our knowledge we are currently the only company offering such a unique solution in the hardware networking appliance industry.

The principal applications of the SETAC products are the same as the principle applications of our Server Adapter products described above (including security appliances, WAN optimization appliances, video on demand servers, and internet service providers/web hosting). The SETAC products apply to the same target markets as the Server Adapter products, but also extend to two additional types of customers - server manufacturers and system integrators.

As with our Server Adapter line of products, the business model for our SETAC products is the Design Win Model.

Interest for the specific solution provided by the SETAC products is continuously growing in the hardware networking appliances market and orders for such products were placed throughout 2010, 2011 and 2012 and continue into 2013. We cooperate with security industry companies, system integrators and server manufacturers, integrating SETAC units with a “server grade” motherboard and other system components. In August 2010, for instance, we established significant cooperation with a pioneering developer and manufacturer of high-performance server platforms, and with a major vendor in the security industry, who has incorporated our SETAC products in their next-generation lines of security appliances that was launched in 2011. As of January 2011, the OEM division of a leading server manufacturer and a global provider of purpose-built platforms and appliances began offering appliances which integrate Silicom’s SETAC products with a popular model of the server manufacturer's standard servers, thus enabling their customers to use the manufacturer’s top quality servers as highly-flexible customized network appliances. In May 2011 we achieved two Design Wins for Networking Modules, a product line that we developed as a part of our SETAC Server-to-Appliance Converter strategy. One was with a dominant player in the global security market who will use our modules in several appliances to enable the reconfiguration of their ports without opening the appliance chassis. The second was with a leading company in the Traffic Management and Policy Enforcement industry who has decided to standardize on our connectivity modules within its custom-built appliances. In October 2011 we announced that one of the world’s largest networking companies has standardized the use of Silicom’s SETAC Server To Appliance Converter kits in some of its network appliance product lines. In March 2012 we announced the first Design Win for the use by a telecom operator of the SETAC Server-To-Appliance-Converter products in a server-based carrier-grade network appliance platform. In October 2012 we announced that the security division of one of the world’s largest server manufacturers has awarded the Company a major new Design Win for its SETAC-derivative 1Gbps and 10Gbps Fiber Bypass modules. This is our first win with this Tier-1 conglomerate, which has already placed initial orders as a part of the award. The Design Win followed an evaluation conducted jointly by the customer and its appliance vendor. Furthermore, at the same time we also announced that two European Internet Security solution providers and one European mobile broadband network optimization and acceleration provider chose the full SETAC-based solution to use as the platform for their appliances.

In light of increasing demand for SETAC products and SETAC-derivative modules throughout 2010, 2011 and 2012, we believe that such products have turned into one of the drivers of our revenues, and will continue as such in the coming years.

#### Principal Markets

The principal markets in which we compete are set forth more particularly in, and are incorporated by reference to Note 10 to the consolidated financial statements set forth in Item 18 of this annual report. In 2010, 2011 and 2012, approximately, 72%, 75% and 69% respectively, were in North America, 14%, 13% and 15% respectively, of our sales were in Europe, and 14%, 12% and 16% respectively, were in other countries. Our main business is not seasonal, and we believe that there are sufficient sources and raw materials available to sustain it.

## Sales and Marketing

Over the last few years, our sales and marketing has been carried out through a network of strategic relationships with leading original equipment manufacturers which sell our products, generally as a part of their systems and sometimes under their own private labels. Our current original equipment manufacturer customers are mostly active in the security appliances market, WAN optimization market, other network appliances markets (such as load balancing and traffic management), storage market, general servers market and other server based applications. They are referred to in this report as OEMs, or OEM customers. Our strategy of carrying out strategic relationships with OEM customers continues to be the strategy under which we operate. We believe that these relationships enable us to take advantage of the superior financial resources and market presence of these companies to increase our sales and establish, maintain and strengthen our position and reputation in the market. In addition, we believe that relationships with OEMs improve access to new technologies developed by such OEMs, thereby ensuring smooth integration of our products and technology with those of the OEMs. In furtherance of this strategy, from 2005 through 2012 we entered into strategic arrangements with OEMs and continued securing successful Design Wins with OEMs who purchase our products. Revenues from sales of our products to OEM customers in 2012 constituted approximately 99% of our revenues. We expect the percentage of our revenues that is derived from sales of connectivity products to OEM customers to continue at similar levels, as we continue to focus our efforts on our Server Adapter products, which are sold mostly to OEMs, and begin to focus on SETAC products, which are currently and will continue to be sold mostly to OEMs.

As such, the loss of some of our OEM customers, or any single key OEM customer, may have a material adverse effect on our operations and financial results and we cannot assure you that we will be able to enter into strategic relationships with OEMs in the future. Our other non-OEM products are marketed directly, through our U.S.-based subsidiary and through a network of independent distributors. Normal payment terms of our OEM customers are up to 90 days net. Substantially all of our international sales are denominated in U.S. dollars and may be subject to government controls and other risks, including, in some cases, export licenses, federal restrictions on export, currency fluctuations, political instability, trade restrictions and changes in tariffs and freight rates. We have experienced no material difficulties to date as a result of these factors.

Our arrangements with our OEM customers (and distributors and resellers when applicable) are generally non-exclusive. We have generally experienced good relations with our customers and are not aware of any pending terminations other than with respect to products that newer technologies have eliminated the need for.

Our OEM customers, distributors and resellers are not within our control. They are not obligated to purchase products from us and may represent other lines of products. A reduction in sales effort or discontinuance of sales of our products by our OEM customers could lead to reduced sales and could materially adversely affect our operating results. Use of OEMs also entails the risk that OEMs will build up inventories in anticipation of a growth in sales. If such growth does not occur as anticipated, these OEMs may substantially decrease the amount of products ordered from us in subsequent quarters, discontinue product orders or even attempt to return unsold products. The loss or ineffectiveness of several of our OEM relationships at approximately the same time, or the loss of any key OEM customer, might have a material adverse effect on us.

## Research and Product Development

Since we commenced operations, we have conducted extensive research, development and engineering activities. Our efforts emphasize the development of new products, cost reduction of current products, and the enhancement of existing products, generally in response to rapidly changing customer preferences, technologies and industry standards. During 2003-2012 we fully matured our line of Multi-Port Server Adapter products and further invested in the development of other products including development of cards incorporating bypass functionality, addition of a full line of PCI-Express cards based on both chipsets we used for the PCI-X based cards, supplementing a line of PCI-Express bypass cards and adding a line of ROHS compliant cards for PCI-X cards (as PCI-Express cards were originally designed to be ROHS compliant). During 2006 we launched a product line of high-performance encryption cards designed to improve the throughput of internet security appliances and network gateways. The products improve the performance of networking appliances by independently executing encryption tasks, thereby accelerating the encryption process and freeing the CPUs of such appliances for other activities. During 2007, we enhanced our offering of encryption cards by adding a line of encryption products which is based on a second chipset manufacturer, positioning ourselves again (just like with the networking adapters) as an independent supplier which is able to deliver such cards based on chipsets delivered by the leaders in this industry. In addition, during 2007, we developed a line of stand-alone bypass solutions which allow the use of our solutions even where the networking component of the solution is already present. Also, during 2007, we worked to develop a series of 10Gbps adapters, based both on Intel chips and on Broadcom chips. During 2008, due to market demand we added two more stand-alone bypass units: 1. Entry level bypass switch 1/10Gbps, directed at power failure bypass. 2. High end 10Gbps intelligent bypass switch with self generating heartbeat and versatile monitoring and control options.

During 2008-2012 we continued to focus our efforts on the 10Gbps series, and we currently have the following families of 10Gbps cards: (1) our main family of 10Gbps cards consists of 10Gbps adapters with and without bypass, with both Intel and Broadcom controllers, including several interface options (such as XFP, CX4, SFP+ and 10GbaseT), (2) the family of redirector cards, which integrates intelligent packet filtering, multi-port connectivity and automated bypass on a single networking card, and (3) the family of encryption acceleration cards. In addition to the abovementioned redirector cards, we are also developing other cards which enable intelligent offloading of server tasks. During the above period, we also added intelligent stand alone bypass units. The stand alone bypass unit is a switch that protects network integrity from network failures and network maintenance.

From 2008 to 2012 we developed the SETAC, a new product family, and in June 2012 we were issued patent No. 8,199,523 entitled 'Server-Based Network Appliance' from the United States Patent and Trademark Office with respect to our SETAC product. SETAC enables branded high technology servers to be configured as hardware appliances, and creates an ideal network appliance that combines server grade reliability, front-end access, field-replaceable architecture and a stable state-of-the-art technology environment. The SETAC product line includes SETAC converters (comprised of PCI-Express G2 adapter, cables and the Silicom backplane) that are used to interface with Silicom's front loading I/O Express Modules. Leveraging a standard server's configuration, the SETAC products are installed through placing Silicom's I/O Express Modules into the server's "hot-swap" hard drive slots. Through the use of the SETAC, the customer will be giving its new security appliance field re-configurability, flexibility and other desirable functions without sacrificing the use of a branded, highly-reliable and supportable basic platform.

During 2011-2012, we developed the DNA (Direct NIC Access) driver and feature set to enable high rate capture, analysis and filtering while leveraging our existing range of networking cards. DNA allows a line-rate of 10Gbps RX/TX and uses the cards' abilities to deliver packets directly to and from the user space while offloading tasks such as filtering and QOS from the CPU.

During 2012, we developed the Lib Zero, a library that implements packet sharing in zero-copy. LibZero is able to operate at line rate with any packet size, and implements basic RX/TX capabilities, giving developers a flexible packet processing framework in addition to DNA that is implemented in zero-copy. This framework "fills the gap," delivering missing functionality including:

- Packet distribution across threads, cores and applications
- User-configurable, packet hashing for flexible packet distribution
- Packet filtering and efficient packet forwarding across network interfaces

During 2012, we developed a Nano-Second Time-Stamping NIC. The NIC combines Intel's networking silicon and the Company's time-stamping FPGA (field programmable gate array), working at wire speed to time-imprint packets.

On February 14, 2013, we filed a patent application in the United States, the "Network Adapter with High Performance In-Line Timestamp", to protect our proprietary information with respect to Ethernet-managed network interface cards.

We cannot assure you that any of our development efforts will result in commercially successful products, that such products will be released in a timely manner or that we will be able to respond effectively to technological changes or new product announcements by our competitors.

The markets for our products are characterized by rapidly changing technology and evolving industry standards. We believe that success will depend upon our ability to successfully market new networking and connectivity concepts and, to a lesser extent, upon our ability to enhance our existing products and to continue to introduce new products on a timely basis. Accordingly, we intend to make substantial investments in technology development. Notwithstanding these efforts, we cannot assure you that we will be successful in selecting, developing, manufacturing and marketing our technology or our enhanced and new products in a timely manner.

## Manufacturing and Suppliers

Our manufacturing operations consist primarily of producing finished goods from components and sub-assemblies purchased from third parties. In addition, we perform testing and quality assurance procedures with respect to the components and sub-assemblies which are incorporated into our final products and the final products themselves.

We seek to monitor quality with respect to each stage of the production process including, but not limited to, the selection of component suppliers, warehouse procedures and final testing, packaging and shipping. We have been certified as complying with "ISO 9001:2000", which is a quality control standard used in our industry. We believe that our quality assurance procedures have been instrumental in achieving a high degree of reliability for our products. We intend to continue to maintain and improve the efficiency of such procedures.

Although we generally use standard parts and components for our products, certain key components used in our products are currently available from only one source, and others are available from a limited number of sources. Components currently available from one source include proprietary Gigabit Ethernet chipsets and other components, including other semiconductor devices and transformers, as well as plastic and metal product housings. We believe that we maintain a sufficient inventory of these components to protect against delays in deliveries. There can be no assurance that we will not experience delays in the supply of critical components in the future or that we will have a sufficient inventory of critical components at such time to produce products at full capacity. If we do experience such delays and there is an insufficient inventory of critical components at that time, our operations and financial results would be adversely affected.

We are generally required to fill orders for our products within one or two weeks after receipt of a firm purchase order. Consequently, we need to maintain inventory at levels that are in accordance with our forecasts and those of our customers. There can be no assurance that such forecasts will indeed materialize into firm purchase orders and consequently we cannot guarantee that the full volume of such inventory will be delivered against firm purchase orders and not remain unused.

## Competition

The data server adapters industry is highly competitive. We face competition from numerous companies, some of which are more established, benefit from greater market recognition and have greater financial, production and marketing resources than we do. We cannot guarantee that our present or any contemplated products will continue to be distinguishable from those of our competitors or that the marketplace will find our products preferable to those of our competitors. Furthermore, there can be no assurance that competitive pressures will not result in price reductions that could materially adversely affect our business and financial condition and the results of our operations.

In the server networking industry for which we have developed our Multi-Port Gigabit-Ethernet Server Networking cards, our main competitor is Intel. In the bypass cards industry, our competition is not as significant. To the best of our knowledge, our only significant competitors in this industry are Interface Masters, Portwell and Adlink. There may be other local solutions which might compete with our products. In the external bypass cards industry (in which solutions are offered in the form of an external box instead of an embedded card), to the best of our knowledge our main competitor is Netoptics, and to some degree also Interface Masters.

To the best of our knowledge, there is no direct competition to our unique SETAC products. As network appliances may be built based on either standard servers or special hardware appliances, our SETAC products improve and enhance the competitive positioning of standard servers in the network appliance industry compared to the special hardware appliances alternative. We believe that the products offered by suppliers of special hardware appliances such as Portwell, Nexcom, Lanner and Advantech do not provide the advantages of the SETAC solution and therefore constitute only non-direct competition.

#### Intellectual Property Rights and Software Protection

Our success and ability to compete are dependent to a significant degree on our technology. In order to establish and protect the technology we use in our products, we primarily rely on a combination of non-disclosure agreements and technical measures, and to a lesser degree on patent. These measures afford only limited protection, and accordingly, there can be no assurance that the steps we take will be adequate to prevent misappropriation of our technology or the independent development of similar technologies by others. Despite our efforts to protect our technology, unauthorized parties may attempt to copy aspects of our products and develop similar hardware or software or to obtain and use information that we regard as proprietary. In addition, there can be no assurance that one or more parties will not assert infringement claims against us. The cost of responding to claims could be significant, regardless of whether the claims are valid.

On April 8, 2010, we filed a patent application in the United States the "Server-Based Network Appliance", to protect our proprietary intellectual property with respect to SETAC products. On June 12, 2012 we were issued patent No. 8,199,523 entitled 'Server-Based Network Appliance' from the United States Patent and Trademark Office with respect to our SETAC product. The patent will expire in October, 2030. The patent covers a server-based network appliance in which a computer motherboard is mounted in a case with the bus slots of the motherboard adjacent to the rear side of the case. Communication adapter cards are mounted in the case so that the ports of these cards are accessible at the front panel. Bus extension circuitry inside the case connects the bus slots on the motherboard with the communication adapter cards, as though the cards were plugged into the motherboard. This configuration, which is used in the our SETAC product, gives the convenience of connecting and replacing modules via the front panel while using standard motherboards, which are not normally designed for front-panel access. We have also filed Chinese patent application 201080012696X covering this same invention and claiming priority from the above US patent. The Chinese patent application is awaiting examination by the State Intellectual Property Office (SIPO).



On February 14, 2013, we filed a patent application in the United States, the "Network Adapter with High Performance In-Line Timestamp", to protect our proprietary information with respect to Ethernet-managed network interface cards.

We cannot assure you that the scope of any issued patent will adequately protect our intellectual property rights, or that patents will not be challenged, invalidated or circumvented or that the rights granted under the patents will provide us with meaningful protection or any commercial advantage. For additional information regarding the risks to the Company with respect to patents and other intellectual property rights see the risk factor entitled "We may not be able to protect our intellectual proprietary rights" under Item 3.D - "Risk Factors".

#### Governmental Regulation Affecting the Company

We are affected by the terms of research and development grants we have received from the Office of the Chief Scientist of Israel ("OCS"). Under the terms of Israeli Government participation, a royalty of 2% or up to 5% of the net sales of products developed from a project funded by the OCS must be paid, beginning with the commencement of sales of products developed with grant funds and ending when a dollar-linked amount equal to 100% of such grants plus interest at LIBOR is repaid. The terms of Israeli Government participation also impose significant restrictions on manufacturing outside Israel of products developed with government grants. The transfer to third parties of technologies developed through such projects is subject to approval of the OCS. There can be no assurance that such approval, if requested, will be granted on reasonable commercial terms.

In addition, we receive certain tax benefits and reduced tax rates from the Israeli government due to our status as a "Benefited Enterprise" under the Law for the Encouragement of Capital Investments-1959, as amended. See "Item 10. Additional Information – Taxation." The entitlement to these benefits is conditional upon our fulfillment of the conditions stipulated by the law, regulations promulgated thereunder and the instruments of approval for the specific investments. In the event of failure to comply with these conditions, the benefits could be canceled and we would be required to refund the amount of the benefits, in whole or in part, with the addition of linkage differences and interest.

#### C. Organizational Structure

We have one wholly owned subsidiary, which is incorporated in the United States, under the name Silicom Connectivity Solutions, Inc. Two of our founders, Messrs. Yehuda and Zohar Zisapel, are also founders, directors and principal shareholders of several other corporations within the "Rad Group". See Item 7. "Major Shareholders and Related Party Transactions" for additional information on our relationships with members of this group of companies.

D. Property, Plant and Equipment

We do not own any real property, but we lease property at three locations. Our executive offices and research and development facilities are located in Kfar Sava, Israel. In November 2007, we renewed the term of the lease for our Kfar Sava offices until December 31, 2008, and have been extending such lease each year. During 2012 we extended the lease further for an additional year until December 31, 2013. The facility is approximately 1,050 square meters in size, and we currently pay monthly rent of approximately \$15,000.

We have conducted our manufacturing in Yokneam, Israel since 2000, and in January 2009, we moved to a new facility in Yokneam, and entered into a lease for a period of two years, ending in December 31, 2010, with an option to renew the terms for an additional period of three years. On December 31, 2010 we renewed the lease for such additional period, until December 31, 2013. This facility is approximately 913 square meters in size plus additional warehouse areas of approximately 456 square meters in size, and the monthly rent payments are approximately \$17,000.

As of February 2004, we sub-lease office space in Paramus, New Jersey, from our affiliate. On January 1, 2013, we extended the sub-lease for this space for an additional one-year period until December 31, 2013. Currently, the monthly rent payments for this space are approximately \$1,000. See “Item 7 – Major Shareholders and Related Party Transactions.”

We believe that our facilities in Israel and in the United States are suitable and adequate for our operations as currently conducted. In the event that additional facilities are required or we need to seek alternative rental properties, we believe that we could obtain such additional or alternative facilities at commercially reasonable prices.

Item 4A. UNRESOLVED STAFF COMMENTS

There are no unresolved staff comments.

Item 5. OPERATING AND FINANCIAL REVIEW AND PROSPECTS

General

Silicom was incorporated in Israel and commenced operations in 1987. We have traditionally been engaged in the design, manufacture, marketing and support of connectivity solutions for computers. In the years 2000 and 2001, we leveraged the IP developed in this area for use in the broadband internet access market. In late 2002, we leveraged our expertise and know-how in networking and operating systems to develop a line of high-end server networking cards, recording growing sales of these products in 2004-2007. In 2008 we recorded sales of these products of approximately \$25.6 million, and in 2009 we recorded sales of approximately \$20.5 million. In 2010 we leveraged our expertise and know-how in networking solutions and launched our new SETAC (Server To Appliance Converter) product line. In 2010, 2011 and 2012 we recorded sales from all of our networking solutions of approximately \$30.4 million, \$39.6 million and \$48.7 million, respectively. We primarily sell our products through original equipment manufacturers and, to a lesser extent, through independent distributors (on a non-exclusive basis).

## Critical Accounting Policies

The discussion and analysis of our financial condition and results of operations are based upon our consolidated financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States. The preparation of these financial statements requires us to make estimates and judgments that affect the reported amount of assets and liabilities, revenues and expenses, and related disclosure of contingent assets and liabilities at the date of our financial statements. Actual results may differ from these estimates under different assumptions or conditions.

Critical accounting policies are defined as those that are reflective of significant judgments and uncertainties, and could potentially result in materially different results under different assumptions and conditions. We believe that our critical accounting policies are limited to those described below.

- **Inventories** - Inventories are stated at the lower of cost or market. Cost is determined using the "average-cost" method. We write down obsolete or slow moving inventory to its market value.
- **Marketable securities** – We account for investments which we intend and are able to hold to maturity, that are classified as held-to-maturity investments as defined in ASC 320-10, "Accounting for Certain Investments in Debt and Equity Securities".

When other-than-temporary impairment has occurred, the amount of the other-than-temporary impairment recognized in earnings depends on whether we intend to sell the security or more likely than not will be required to sell the security before recovery of its amortized cost basis less any current-period credit loss. If we intend to sell the security or more likely than not will be required to sell the security before recovery of its amortized cost basis less any current-period credit loss, the other-than-temporary impairment is recognized in earnings equal to the entire difference between the amortized cost basis of the investment and its fair value at the balance sheet date. If we do not intend to sell the security and it is not more likely than not that we will be required to sell the security before recovery of its amortized cost basis less any current-period credit loss, the other-than-temporary impairment is separated into the amount representing the credit loss and the amount related to all other factors. The amount of the total other-than-temporary impairment related to the credit loss is recognized in earnings.

- Allowance for doubtful accounts - Trade receivables are recorded less the related allowance for doubtful accounts receivable. We consider accounts receivable to be doubtful when it is probable that we will be unable to collect all amounts, taking into account current information and events regarding our customers' ability to repay their obligations. The balance sheet allowance for doubtful debts is determined as a specific amount for those accounts the collection of which is uncertain. We perform our estimates regarding potential doubtful debts based on payment history and correspondence with our customers, and based on new information we receive about the customers' financial situation. As of December 31, 2012, the allowance for doubtful debts was \$20 thousand.

§Deferred Taxes - We account for income taxes under ASC 740-10 (formally known as SFAS No. 109), "Accounting for Income taxes". Under ASC 740-10, deferred tax assets and liabilities are recognized for the future tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases, and operating loss and tax credit carry forwards. Deferred tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. The effect on deferred tax assets and liabilities of a change in tax rates is recognized in income in the period that includes the enactment date. Valuation allowances are established when necessary to reduce deferred taxes assets to the amount expected to be realized. Valuation allowances in respect of deferred taxes were recorded in respect of the following matter:

§Deferred tax assets that, as we believe, are more likely than not to be realized. In assessing the potential of realization of deferred tax assets, we consider projected future taxable income and tax planning strategies.

Deferred tax assets and liabilities are classified as current or non-current items in accordance with the nature of the assets or liabilities to which they relate. When there are no underlying assets or liabilities the deferred tax assets and liabilities are classified in accordance with the period of expected reversal. Income tax expenses represent the tax payable for the period and the changes during the period in deferred tax assets and liabilities. As of December 31, 2012, the deferred tax assets were \$161 thousand. In 2010 and in 2011, all of the valuation allowance referred to loss carry-forward related to Silicom Connectivity Solutions, Inc. In 2012 Silicom Connectivity Solutions, Inc. utilized all of its loss carry-forward and therefore all related deferred tax assets and valuation allowance were derecognized.

We recognize the effect of income tax positions only if those positions are more likely than not of being sustained. Recognized income tax positions are measured at the largest amount that is greater than 50% likely of being realized. Changes in recognition or measurement are reflected in the period in which the change in judgment occurs.

ASC 740 (FASB Interpretation No. 48), "Accounting for Uncertainty in Income Taxes" clarifies the accounting for uncertainty in income taxes recognized in an enterprise's financial statements. This interpretation prescribes a minimum recognition threshold a tax position is required to meet before being recognized in the financial statements. ASC 740 also provides guidance on derecognition of tax positions, classification on the balance sheet, interest and penalties, accounting in interim periods, disclosure, and transition. ASC 740 requires significant judgment in determining what constitutes an individual tax position as well as assessing the outcome of each tax position.

As of January 1, 2012 and for the twelve months ended December 31, 2012, we did not have any unrecognized tax benefits. In addition, we do not expect that the amount of unrecognized tax benefits will change significantly within the next 12 months.

- Impairment or disposal of long lived assets - We account for long-lived assets in accordance with the provisions of ASC subtopic 360-10 (SFAS No. 144), "Property plant and equipment - overall". This Statement requires that long-lived assets be reviewed for impairment 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 future undiscounted net cash flows expected to be generated by the asset. If the carrying amount of an asset exceeds its estimated future cash flows, an impairment charge is recognized for the amount by which the carrying amount of the asset exceeds the fair value of the asset. Fair value is being determined using discounted cash flow models. Assets to be disposed would be separately presented in the balance sheet and reported at the lower of the carrying amount or fair value less costs to sell.
- Accounting for Stock-Based Compensation - The Company recognizes compensation expense in accordance with ASC topic 718, "Compensation – stock compensation" based on estimated grant date fair value using an option-pricing model. The share-based awards granted after January 1, 2008 include features that are not supported by the Black and Scholes valuation model, such as an expiration date to occur if the closing price of the Shares falls below 50% of the grant date Share price. Therefore for share-based awards granted after January 1, 2008, the Company recognizes compensation expense based on estimated grant date fair value using the Monte Carlo option-pricing model, or the Binomial option-pricing model.

## Recently Enacted Accounting Pronouncements Not Yet Adopted

In December 2011, the FASB issued ASU No. 2011-11, Balance Sheet (Topic 210): Disclosures about Offsetting Assets and Liabilities. ASU 2011-11 requires an entity to disclose information about offsetting and related arrangements to enable users of financial statements to understand the effect of those arrangements on its financial position, and to allow investors to better compare financial statements prepared under U.S. GAAP with financial statements prepared under International Financial Reporting Standards (IFRS). The new standards are effective for annual periods beginning January 1, 2013, and interim periods within those annual periods. Retrospective application is required. We will implement the provisions of ASU 2011-11 as of January 1, 2013.

## A. Operating Results

You should read the following management's discussion and analysis of our financial condition and operating results in conjunction with the consolidated financial statements and the related notes thereto included in this annual report. The following table sets forth, for the periods indicated, the relationship (in percentages) of items from our Consolidated Statement of Operations Data to our total sales:

Year Ended December 31,

	2010		2011		2012	
Sales	100	%	100	%	100	%
Cost of sales	57.5		56.6		59.2	
Gross profit	42.5		43.4		40.8	
Research and development costs	10.8		10.5		9.0	
Selling and marketing expenses	7.3		6.7		6.3	
General and administrative expenses	5.0		4.8		4.9	
Operating Income	19.4		21.4		20.6	
Financial income, net	2.0		1.1		1.5	
Income before income taxes	21.4		22.5		22.1	
Income tax expenses	2.6		1.7		1.8	
Net Income	18.8		20.8		20.3	

Sales in 2012 increased by 23.0% to 48,729 thousand compared to \$39,633 thousand in 2011. The increase in sales is mostly attributed to the following factors: many existing customers continued increasing their ongoing orders; some of our larger customers continued integrating additional Silicom products into their product lines; and, we continued expanding our customer base. The increase in sales is also affected, among other factors, by the growing interest of the market in our new product lines.

Sales in 2011 increased by 30.4% to \$39,633 thousand compared to \$30,399 thousand in 2010. The increase in sales is mostly attributed to the following factors: many existing customers continued increasing their ongoing orders; some of our larger customers continued integrating additional Silicom products into their product lines; and, we continued expanding our customer base. The increase in sales is also affected, among other factors, by the growing interest of the market in our new product lines including the SETAC products.

Gross profit in 2012 was \$19,880 thousand compared to \$17,203 thousand in 2011. Gross profit as a percentage of sales in 2012 was 40.8%, compared to 43.4% in 2011. Our gross profit is largely dependent on the mix of products we sell during a specific year. The lower gross profit percentage in 2012 compared to 2011 was primarily a result of changes to the mix of products we sold in 2012. Gross profit is also affected, among other factors, by write-downs of inventory made with respect to any obsolete or slow moving inventory we can no longer use. The inventory write-downs as a percentage of sales in 2012 decreased to 1.8%, compared to 1.9% in 2011.

Gross profit in 2011 was \$17,203 thousand compared to \$12,909 thousand in 2010. Gross profit as a percentage of sales in 2011 was 43.4%, compared to 42.5% in 2010. Our gross profit is largely dependent on the mix of products we sell during a specific year. The higher gross profit percentage in 2011 compared to 2010 was primarily a result of changes to the mix of products we sold in 2011. Gross profit is also affected, among other factors, by write-downs of inventory made with respect to any obsolete or slow moving inventory we can no longer use. The inventory write-downs as a percentage of sales in 2011 decreased to 1.9%, compared to 2.6% in 2010.

Research and development costs in 2012 increased by 5.7% to \$4,401 thousand compared to \$4,165 thousand in 2011. This increase was mainly attributed to our continued investment in new product development, enhancements to existing products and the development of new networking and connectivity technologies, which contributed approximately \$520 thousand to such increase. Thus, there was an increase in our research and development costs in 2012, despite the effect of a relative strengthening of the US Dollar against the New Israeli Shekel, which contributed approximately \$280 thousand to a decrease in the research and development costs (since a significant portion of our research and development expenses are incurred in New Israeli Shekels) which decrease was more than offset by the factors outlined above.

Research and development costs in 2011 increased by 27.0% to \$4,165 thousand compared to \$3,280 thousand in 2010. This increase was mainly attributed to our continued investment in new product development, enhancements to existing products and the development of new networking and connectivity technologies, which contributed approximately \$740 thousand to such increase, and to a relative weakening of the US Dollar against the New Israeli Shekel (since a significant portion of our research and development expenses are incurred in New Israeli Shekels), which contributed approximately \$150 thousand to such increase.

Selling and marketing expenses in 2012 increased by 15.1% to \$3,081 thousand compared to \$2,677 thousand in 2011. This increase was mainly attributed to our continued investment in the promotion of our server networking products, which contributed approximately \$510 thousand to such increase. Thus, there was an increase in the selling and marketing expenses, despite the effect of a relative strengthening of the US Dollar against the New Israeli Shekel which contributed approximately \$110 thousand to a decrease in the selling and marketing expenses (since a significant portion of our selling and marketing expenses are incurred in New Israeli Shekels), which decrease was more than offset by the factors outlined above.

Selling and marketing expenses in 2011 increased by 21.3% to \$2,677 thousand compared to \$2,207 thousand in 2010. This increase was mainly attributed to our continued investment in the promotion of our server networking products, which contributed approximately \$410 thousand to such increase, and to a relative weakening of the US Dollar against the New Israeli Shekel (since a significant portion of our selling and marketing expenses are incurred in New Israeli Shekels), which contributed approximately \$60 thousand to such increase.

General and administrative expenses in 2012 increased by 25.3% to \$2,369 thousand compared to \$1,890 thousand in 2011. This increase was mainly attributed to the growth in our activity as demonstrated by the increase in our sales which amounted to 23.0%, which contributed approximately \$620 thousand to such increase. Thus, there was an increase in the general and administrative expenses despite the effect of a relative strengthening of the US Dollar against the New Israeli Shekel which contributed approximately \$140 thousand to a decrease in the general and administrative expenses (since a significant portion of our general and administrative expenses are incurred in New Israeli Shekels), which decrease was more than offset by the factors outlined above.

General and administrative expenses in 2011 increased by 24.1% to \$1,890 thousand compared to \$1,523 thousand in 2010. This increase was mainly attributed to the growth in our activity as demonstrated by the increase in our sales which amounted to 30.4%, which contributed approximately \$300 thousand to such increase, and to a relative weakening of the US Dollar against the New Israeli Shekel (since a significant portion of our general and administrative expenses are incurred in New Israeli Shekels), which contributed approximately \$70 thousand to such increase.

Financial income, net in 2012 increased by 71.3% to \$752 thousand compared to \$439 thousand in 2011. The increase was primarily caused by the relative strengthening of the US dollar against the New Israeli Shekel (a significant portion of our balance sheet assets and obligations are denominated in New Israeli Shekels), which created a net financial income in US dollars from exchange rate differences, and the increase in funds available for investment.

Financial income, net in 2011 decreased by 28.8% to \$439 thousand compared to \$617 thousand in 2010. The decrease was primarily caused by the relative weakening of the US dollar against the New Israeli Shekel (a significant portion of our balance sheet assets and obligations are denominated in New Israeli Shekels), which created a net financial expense in US dollars from exchange rate differences, and the decrease in yields from investments in marketable securities. Thus, despite the increase in funds available for investment, there was a decrease in financial income in 2011.



In 2012 we recorded current income tax expenses of \$900 thousand and deferred income tax expenses of \$22 thousand compared to current income tax expenses of \$619 thousand and deferred income tax expenses of \$86 thousand in 2011. In addition, in 2012 we recorded income tax benefit relating to former years (tax returns) of \$12 thousand, and in 2011 we recorded income tax benefit relating to former years (tax returns) of \$38 thousand.

In 2011 we recorded current income tax expenses of \$619 thousand and deferred income tax expenses of \$86 thousand compared to current income tax expenses of \$657 thousand and deferred income tax expenses of \$156 thousand in 2010. In addition, in 2011 we recorded income tax benefit relating to former years (tax returns) of \$38 thousand, and in 2010 we recorded income tax benefit relating to former years (tax returns) of \$12 thousand.

In 2012 we recorded net income of \$9,871 thousand compared to net income of \$8,243 thousand in 2011, a 19.8% increase. This increase was mainly due to our higher sales in 2012.

In 2011 we recorded net income of \$8,243 thousand compared to net income of \$5,715 thousand in 2010, a 44.2% increase. This increase was mainly due to our higher sales in 2011.

#### Impact of Inflation and Currency Fluctuations on Results of Operations, Liabilities and Assets

Since the majority of our revenues are denominated and paid in U.S. dollars, we believe that inflation in Israel and fluctuations in the U.S. dollar exchange rate do not have any material effect on our revenue. Inflation in Israel and the Israeli currency as well as U.S. dollar exchange rate fluctuations, may however, have an effect on our expenses and, as a result, on our net income/loss. The cost of our Israeli operations, as expressed in U.S. dollars, is influenced by the extent to which any change in the rate of inflation in Israel is not offset (or is offset on a lagging basis) by a change in valuation of the NIS in relation to the U.S. dollar.

We do not presently engage in any hedging or other transactions intended to manage the risks relating to foreign currency exchange rate or interest rate fluctuations. However, we may in the future undertake such transactions, if management determines that it is necessary to offset such risks.

#### B. Liquidity and Capital Resources

As of December 31, 2012, we had working capital of \$46,094 thousand and our current ratio (current assets to current liabilities) was 4.91. Cash and cash equivalents as of December 31, 2012 increased by \$1,823 thousand to \$13,306 thousand, compared to \$11,483 thousand as of December 31, 2011. Short-term bank deposits decreased by \$2,483 thousand to \$2,527 thousand, compared to \$5,010 thousand as of December 31, 2011. Short-term marketable securities increased by \$3,556 thousand to \$12,583 thousand and long-term marketable securities increased by \$4,802 thousand to \$28,469 thousand. The net increase of \$7,698 thousand in these four balance sheet items in 2012 was mainly due to net cash provided by operating activities.

Trade receivables increased to \$12,391 thousand as of December 31, 2012, compared to \$8,613 thousand as of December 31, 2011, mainly due to the increase in sales in the fourth quarter of 2012, as compared to sales in the fourth quarter of 2011. Other receivables increased to \$2,234 thousand as of December 31, 2012, compared to \$1,597 thousand as of December 31, 2011.

Trade payables increased to \$7,875 thousand as of December 31, 2012, compared to \$3,978 thousand as of December 31, 2011, mainly due to the increase in inventory in the fourth quarter of 2012, as compared to inventory in the fourth quarter of 2011.

Other payables and accrued liabilities increased to \$3,914 thousand as of December 31, 2012, compared to \$2,460 thousand as of December 31, 2011.

Cash provided by operating activities in 2012 amounted to \$8,889 thousand compared to \$4,691 thousand in 2011. The cash provided by operating activities in 2012 was the result of our positive operating income.

Inventories increased to \$14,795 thousand as of December 31, 2012, compared to \$11,173 thousand as of December 31, 2011, mainly due to the fact that as our sales grow and customers demand receipt of products within a number of weeks following the issuance of purchase orders, we are required to be ready to deliver our products in accordance with our customers' expectations.

Capital expenditures on property and equipment as of December 31, 2012 were \$807 thousand, compared to \$566 thousand as of December 31, 2011.

We have cash and cash equivalents that we believe are sufficient for our present requirements. Furthermore, our cash resources are sufficient to fund our operating needs for at least the next twelve months.

C. Research and development, patents and licenses, etc.

Because the market for our products is characterized by rapidly changing technology and evolving industry standards, our success depends upon our ability to select, develop, manufacture and market new and enhanced products in a timely manner to meet changing market needs. As such, we invest significant resources in research and new product development, enhancements to existing products, and the development of new networking and connectivity technologies, and we expect to continue to do so.

On April 8, 2010, we filed a patent application in the United States the "Server-Based Network Appliance", to protect our proprietary intellectual property with respect to SETAC products. In June 2012 we were issued patent No. 8,199,523 entitled "Server-Based Network Appliance" from the United States Patent and Trademark Office with respect to our SETAC product. On February 14, 2013, we filed a patent application in the United States, the "Network Adapter with High Performance In-Line Timestamp", to protect our proprietary information with respect to Ethernet-managed network interface cards.

We cannot assure you that the scope of any issued patent will adequately protect our intellectual property rights, or that patents will not be challenged, invalidated or circumvented or that the rights granted under the patents will provide us with meaningful protection or any commercial advantage. For additional information regarding the risks to the Company with respect to patents and other intellectual property rights see the risk factor entitled "We may not be able to protect our intellectual proprietary rights" under Item 3.D - "Risk Factors".

The Government of Israel encourages research and development projects oriented towards products for export or projects which will otherwise benefit the Israeli economy. In each of the three fiscal years from 1999 to 2001, we received grants from the OCS for the development of systems and products. We have received from the OCS up to 30% of certain research and development expenditures for particular projects. Under the terms of Israeli Government participation, a royalty of 2% or up to 5% of the net sales of products developed from a project funded by the OCS must be paid, beginning with the commencement of sales of products developed with grant funds and ending when a dollar-linked amount equal to 100% of such grants without interest, for projects approved prior to December 2000, and plus interest at LIBOR, for amounts received after that date, is repaid. The terms of Israeli Government participation also place restrictions on the location of the manufacturing of products developed with government grants, which, in general, must be performed in Israel, and on the transfer to third parties of technologies developed through projects in which the government participates. See "Item 10. Additional Information - Taxation." We received approximately 20% of certain research and development expenditures for a particular project in 2003 and approximately 30% of such expenditures for a particular project in 2004. We did not have any new grant programs with the OCS from 2005 to 2012. In August 2005, we received approval for a \$54 thousand dollar grant from the Korea-Israel Industrial Research and Development Foundation, or Koril-RDF, in connection with the joint development of a certain product with a Korean company. Under the terms of this grant we are required to repay the amounts received at a rate of 2.5% per year of our gross sales of the product developed with the grant in each such year, until 100% of the grant (and any other sums received from Koril-RDF) are repaid. The annual payment for every year following the first sale of the product will not exceed certain percentages of the amounts received from Koril-RDF. As of January 2006 and to date, our research and development activities have been sponsored and funded by us, and we did not participate in any new encouragement programs or received any additional grants from the OCS or Koril-RDF.

We expect that we will continue to commit resources to research and development in the future. As of February 28, 2013, we employed 38 persons in research and development. In 2010, 2011 and 2012, our research and development expenses were \$3,280, \$4,165 and \$4,401 respectively, constituting approximately 10.8%, 10.5% and 9.0% respectively, of our sales. For additional information concerning commitments to pay royalties on sales of products developed from projects funded by the OCS, see Note 8A to our financial statements included elsewhere in this annual report and see “Item 10. Additional Information - Taxation.”

D. Trend Information

In late 2002, we leveraged our expertise and know-how in networking and operating systems to develop a line of high-end server networking cards (Server Adapters). In today’s network-based environment, there is a growing demand for server-based systems. The markets for such systems are almost continuously growing. Furthermore, the security market is growing due to an increase in demand for security appliances, most of which are server based, and the WAN optimization market is growing due to an increase in demand for better WAN connection between branch offices and headquarters. These two markets are now the main markets in which our Server Adapters provide added value. We began investing in marketing and sales of this line to potential markets and customers during 2003 and received initial purchase orders from a number of sources. We continued to invest in the marketing of these products during 2004-2012. During 2004-2007, the number of purchase orders for these products significantly increased. In 2008 there was a slight decrease in purchase orders as compared with 2007, and in 2009 there was a further decrease in purchase orders as compared with 2008, which was mostly attributed to the generally lower demand for the products due to the global economic downturn. The sales cycles in the markets for our products are long, but once we establish a customer base, each such customer will represent an opportunity for sustained, long-term revenues. During the years 2002-2009, our business was based in its entirety on this product line, which generated all of our revenues, and, during this period, we expected that this product line would continue to be our principal line of business in the coming years, specifically with respect to the 10Gbps cards, higher port density cards, bypass cards and intelligent and programmable cards.

In 2009, despite the impact of the major worldwide economic downturn as discussed above, we continued to be profitable and completed four profitable quarters despite the year’s significant challenges. Furthermore, in the last two quarters of 2009, we were able to restore a process of growth in our business, a trend which continued in 2010, 2011 and 2012. In 2010, the number of purchase orders for our products significantly increased, and we reached our highest revenues to that date. During this period, many of our customers renewed their purchases from us to the level of their purchases prior to the economic crisis. We also made sales associated with new products and customers. In 2011 and 2012, many existing customers continued increasing their ongoing orders, some of our larger customers continued integrating additional Silicom products into their product lines, and we continued to expand our customer base. The increase in sales during 2011 and 2012 was also influenced by, among other factors, the growing interest of the market in our new product lines including the SETAC products. As a result, the number of purchase orders for our products significantly increased even further during 2011 and 2012, and we again achieved our highest level of annual revenues to those dates.

In 2009, 2010, 2011 and 2012 we launched new products, such as our new product family, the new patented SETAC (SErver To Appliance Converter), which received a positive reaction in the market, penetrated our existing customer base and facilitated cooperation with new customers including a significant cooperation at the end of 2010 with a pioneering developer and manufacturer of high-performance server platforms, and with a major vendor in the security industry, who incorporates SETAC products in their next-generation lines of security appliances launched in 2011, and a significant cooperation at the beginning of 2011 with the OEM division of a leading server manufacturer and a global provider of purpose-built platforms and appliances which began offering appliances integrating Silicom's SETAC products with of a popular model of the server manufacturer's standard servers. In May 2011 we achieved two Design Wins for Networking Modules, a product line that we developed as a part of our SETAC Server-to-Appliance Converter strategy. One was with a dominant player in the global security market who will use our modules in several appliances to enable the reconfiguration of their ports without opening the appliance chassis. The second was with a leading company in the Traffic Management and Policy Enforcement industry who has decided to standardize on our connectivity modules within its custom-built appliances. In October 2011 we announced that one of the world's largest networking companies, has standardized the use of Silicom's SETAC kits in some of its network appliance product lines. In March 2012 we announced the first Design Win for the use by a telecom operator of the SETAC products in a server-based carrier-grade network appliance platform. In October 2012 we announced that the security division of one of the world's largest server manufacturers has awarded us a major new Design Win for its SETAC-derivative 1Gbps and 10Gbps Fiber Bypass modules. This is our first win with this Tier-1 conglomerate, which has already placed initial orders as a part of the award. The Design Win followed an evaluation conducted jointly by the customer and its appliance vendor. Furthermore at the same time we also announced that two European Internet Security solution providers and one European mobile broadband network optimization and acceleration provider chose the full SETAC-based solution to use as the platform for their appliances. We believe that as products such as SETAC and SETAC-derivative modules will further prove themselves in commercial deployments, the demand for such products is expected to increase and, consequentially, may turn this product family into one of our growth drivers in future years.

However, although we expect our business and products to further develop in the coming years, there is no assurance that we will continue to generate significant sales in the areas in which we operate.

E. Off-Balance Sheet Arrangements

On July 22, 2002, our Audit Committee and the Board of Directors approved an Indemnification Agreement with our directors and officers. Our shareholders approved the terms of this agreement in a General and Extraordinary Meeting held on January 7, 2004. In the March 2005 amendment to the Israeli Companies Law-1999 ("Companies Law"), the instances in which a company may indemnify its officers and directors were broadened. In December 2007 each of our Audit Committee and Board of Directors approved a new form of Indemnification Agreement with our directors and officers so as to reflect this amendment. Our shareholders approved the terms of this new Indemnification Agreement in January 2008. The Agreement provides that the directors and officers will be exempt from liability in certain circumstances. The Agreement also provides for the indemnification by us for certain obligations and expenses imposed on the officer in connection with an act performed in his or her capacity as an officer of the Company. This right to indemnification is limited, and does not cover, among other things, a breach of an officer's duty of loyalty, a willful breach of an officer's duty of care, or a reckless disregard for the circumstances or consequences of a breach of duty of care. The right to indemnification also does not cover acts that are taken intentionally to unlawfully realize personal gain. The maximum amount of our liability under these Indemnification Agreements for any monetary obligation imposed on an officer or a director in favor of another person by a judgment is currently \$3,000,000 for each instance of a covered scenario. In addition we would be liable to indemnify the officer or director for all reasonable litigation expenses with respect to certain proceedings. We are not aware of any material pending action that may result in anyone claiming such indemnification.

A recent amendment to the Israeli Securities Law, 5728-1968 (the "Israeli Securities Law"), and a corresponding amendment to the Companies Law, authorizes the Israeli Securities Authority to impose administrative sanctions against companies like Silicom Ltd. and their office holders for certain violations of the Israeli Securities Law or the Companies Law. These sanctions include monetary sanctions and certain restrictions on serving as a director or senior officer of a public company for certain periods of time. The amendments to the Israeli Securities Law and to the Companies Law provide that only certain types of such liabilities may be reimbursed by indemnification and insurance. Specifically, legal expenses (including attorneys' fees) incurred by an individual in the applicable administrative enforcement proceeding and certain compensation payable to injured parties for damages suffered by them are permitted to be reimbursed via indemnification or insurance, provided that such indemnification and insurance are authorized by the company's articles of association, and receive the requisite corporate approvals. In January 2012 each of our Audit Committee and Board of Directors approved a new form of Indemnification Agreement with our directors and officers serving in such capacities from time to time so as to reflect this amendment, and at the Annual General Meeting of the Shareholders held on April 11, 2012 our shareholders approved these amendments to the Articles of Association and a revised form of Indemnification Agreement for directors serving in such capacity from time to time.

We are not party to any other material off-balance sheet arrangements or contingent obligations.

## F. Tabular disclosure of contractual obligations

The following table shows our outstanding contractual obligations by category and by payments due as of December 31, 2012:

Contractual Obligations	Total	Payments due by period			More than 5 years
		Less than 1 year	1-3 years	3-5 years	
Operating Leases	848,000	645,000	203,000		
Purchase Obligations	8,663,000	8,663,000			
<b>Total</b>	<b>9,511,000</b>	<b>9,308,000</b>	<b>203,000</b>		

Our total outstanding contingencies in respect of royalty-bearing participations received or accrued, net of royalties paid or accrued before interest, amounted to approximately \$2,960 thousand as of December 31, 2012, of which \$2,782 thousand are attributable to sales of our legacy products and \$178 thousand are attributable to sales of a certain discontinued product.

## Other Long-Term Liabilities Reflected on the Company's Balance Sheet:

The liability for employees' severance benefits amounted to approximately \$2,278 thousand as of December 31, 2012.

The liability for employees' severance benefits is calculated on the basis of the latest monthly salary paid to each employee multiplied by the number of years of employment. The liability is covered by the amounts deposited by us into employees' managers' insurance and/or pension fund accounts in respect of severance obligations to such employees, including accumulated income thereon as well as by the unfunded provision reflected on the balance sheet. Such liability will be removed, either by termination of employment or retirement. While the timing of such obligations cannot be pre-determined (and as such were not included in the above table), such liability will be removed, either by termination of employment or retirement.

## Item 6. DIRECTORS, SENIOR MANAGEMENT AND EMPLOYEES

## A. Directors and Senior Management

The following table and notes thereto set forth information regarding our officers, directors and senior management as of February 28, 2013.

Name	Age	Position with Company
Avi Eizenman	55	Active Chairman of the Board
Shaike Orbach	61	President, Chief Executive Officer, Director
Zohar Zisapel	64	Director
Einat Domb-Har	45	External Director (terms ends as of July 1, 2013)
Ayelet Aya Hayak	43	Nominee for External Director commencing a three year term as of July 1, 2013
Ilan Erez	45	External Director
Eran Gilad	45	Chief Financial Officer





Avi Eizenman co-founded the Company in 1987 and has served as a Director since its inception. Mr. Eizenman also served as our President and Chief Executive Officer from the Company's inception until April 1, 2001, and on such date, he resigned from his positions as President and Chief Executive Officer and was appointed Active Chairman of the Board of Directors. Mr. Eizenman served as head of the ASIC department at Scitex Ltd. in 1986. From 1979 until 1985, Mr. Eizenman held various positions, including project manager, ASIC specialist and engineer, with the Electronic Research & Development Department of the Israeli Ministry of Defense. Mr. Eizenman holds a B.Sc. degree, with honors, in Electrical Engineering from the Technion, and an M.B.A. from Tel Aviv University.

Shaike Orbach has been our President and Chief Executive Officer April 2001. In December 2001, Mr. Orbach was named a Director, replacing Zohar Zisapel, who resigned from the Board of Directors. Prior to that, for a period of four and a half years, Mr. Orbach was President and CEO of Opgal Ltd., a high-tech subsidiary of Israel's Rafael and El-Op corporations. Previously, he was General Manager of Edusoft, an Israeli company the shares of which were traded on the NASDAQ National Market (now, the NASDAQ Global Market), and Managing Director of Tecsys Ltd. He holds a B.Sc degree in Mechanical Engineering from the Technion.

Zohar Zisapel is a co-founder of the Company. He served as a Director from the Company's inception and until 2001. Mr. Zisapel is also a founder and a director of RAD Data Communications Ltd., of which he served as CEO from January 1982 until January 1998 and has served as chairman since 1998. Mr. Zisapel serves as chairman of three other public companies – Ceragon Networks Ltd. (Ticker Symbol CRNT), RADVision Ltd. (Ticker Symbol RVSN) and RADCOM Ltd. (Ticker Symbol RDCM) – and as chairman or director of several private companies belonging to the RAD Group. The Company has certain dealings with members of the Rad Group (see “Item 7. Major Shareholders and Related Party Transactions” below). Since July 2008, Mr. Zisapel has been a director of Amdocs Limited (Ticker Symbol DOX). Mr. Zisapel received a B.Sc. and a M.Sc. in electrical engineering from the Technion, Israel Institute of Technology, and an M.B.A. from Tel Aviv University.

Einat Domb-Har has served as Chief Financial Officer of OneCall Contact Centers Ltd., a company providing Local Lead Generation Network to drive quality phone leads to local businesses since January 2011. From 2006 to 2010 Ms. Domb-Har served as Chief Financial Officer of Olista Ltd., a company providing unique solutions for the cellular industry. From 2004 to 2006 Ms. Domb-Har served as the Chief Financial Officer of Stage One Venture Capital, which focuses on seed investment in the telecom industry. From 2000 to 2004 Ms. Domb-Har served as a controller of Pitango Venture Capital, Israel's largest pool of four venture capital funds. From 1994 to 1999 Ms. Domb-Har served as a senior manager at Kost, Forer and Gabbay, CPA, a member of Ernst & Young International. Ms. Domb-Har is an Israeli Certified Public Accountant and holds a BA in Economics and Accounting from Tel Aviv University. She also holds an M.B.A. from the Israeli extension of Bradford University. Her third and final three-year term as an external director of the Company will end as of July 1, 2013.

Ayelet Aya Hayak was nominated by the Board of Directors to be elected as an external director for an initial three-year term commencing July 1, 2013, with such election to take place at the next Annual Shareholders Meeting of the Company to be held on April 14, 2013. Ms. Hayak serves as a director in several public companies, among which are New Horizon Group Ltd., One Software Technologies (O.S.T.) Ltd., MYDAS Fund Investments Ltd., Danel (Adir Yehushua) Ltd., B.S.R. Projects Ltd., Financitech Ltd., and M.I. Holdings Ltd. Additionally, Ms. Hayak also serves as the chairman of the board of directors of S.D.S (Star Defense Systems) Ltd. Between 2009 and 2011 Ms. Hayak served as the CEO of Paula Ltd. Ms. Hayek holds a BA degree in accounting and business administration from the Tel Aviv College of Management and is also a Certified Public Accountant.

Ilan Erez has served as Chief Financial Officer of Cimatron Ltd. (Ticker Symbol CIMT) engaged in the design and sale of CAD/CAM software for the tool-making and discrete manufacturing industries, since July 2005. From 1998 to 2005 Mr. Erez served as the Chief Financial Officer of the Company. He also served as VP Operations of the Company from May 2001 to 2005. From 1996 to 1998 Mr. Erez served as Controller and assistant to the Chief Executive Officer at Bio-Dar Ltd. From 1994 to 1996 Mr. Erez served as an auditor at Kesselman & Kesselman, a member of Price Waterhouse Coopers. Mr. Erez is a Certified Public Accountant in Israel and holds a B.A in Accounting and Economics from the Hebrew University and an LL.M. in Business Law from Bar-Ilan University. Mr. Ilan Erez has served as an external director of the Company since 2010, and is up for re-election an external director for a second three-year term commencing July 1, 2013, with such re-election to take place at the next Annual Shareholders Meeting of the Company to be held on April 14, 2013.

Eran Gilad has been our Chief Financial Officer since May 2005. From 2002 to 2004 Mr. Gilad served as VP of Finance & Operation at Frontline PCB Solutions Ltd. From 2000 until 2002 Mr. Gilad held senior financial and operational positions at Lynx Photonic Networks Inc. From 1996 until 2000 Mr. Gilad held senior financial positions at Technomatix Technologies Ltd. He is a Certified Public Accountant in Israel and holds an M.A in Economics from Tel-Aviv University and a B.A in Accounting and Economics from Tel-Aviv University.

B. Compensation

The aggregate direct remuneration paid to all persons as a group who served in the capacity of director or executive officer during the year ended December 31, 2012 was \$1,562 thousand. The aggregate amount accrued to provide for severance payments to all persons as a group who served in the capacity of director or executive officer as of the year ended December 31, 2012 was \$988 thousand. The severance terms of our Chief Executive Officer and Chairman of the Board, as approved by the audit committee, board of directors and shareholders of the Company, may entitle them, in certain circumstances, to additional payments. We do not pay cash compensation to Zohar Zisapel for serving on our board of directors. We do pay cash compensation to Avi Eizenman who is an active Chairman of the Board, and to Shaikha Orbach, who is the President and Chief Executive Officer. The external directors receive compensation in accordance with the regulations governing compensation of external directors promulgated under the Israeli Companies Law-1999. All our officers other than the external directors and Mr. Zohar Zisapel work full time for us. Certain of the compensation previously paid to our directors was paid in the form of options under the Silicom Directors Share Incentive Option Plan (1994) (under which there are presently no options outstanding) and certain of such compensation is paid in the form of options under the Share Option Plan (2004) described below.

On October 24, 2000, the board of directors adopted the Silicom Ltd. US Share Option Plan (2000). This Plan is intended to constitute a means of providing additional incentive to officers, consultants and certain other present and future employees and directors of the Company and its subsidiaries. The Plan is administered by the board of directors, which has full authority to grant options under the Plan. Under the terms of the Plan, up to a maximum of 200,000 of our ordinary shares are reserved for issuance, subject to certain adjustments. In total, as of February 28, 2013, we have granted 17,600 options pursuant to the US Share Option Plan (2000) to employees of our US subsidiary – Silicom Connectivity Solutions, Inc., of which 11,300 were returned to the Company due to certain employees who left their positions not exercising their options.

On December 30, 2004, our shareholders adopted our Share Option Plan (2004). Under the original terms of the Share Option Plan (2004) up to a maximum of 282,750 of our ordinary shares are reserved for issuance, subject to certain adjustments, upon the exercise of options granted to employees, directors, officers, consultants and service providers. In December 2007, the Board of Directors increased the number of our ordinary shares available for issuance under the Share Option Plan (2004) by 300,000. In August 2012, the Board of Directors increased the number of our ordinary shares available for issuance under the Share Option Plan (2004) by an additional 500,000. The Share Option Plan (2004) is administered by the board of directors, which designates the optionees, dates of grant, vesting periods and the exercise price of options. The options are non-assignable except by the laws of descent. Certain tax advantages apply to certain of our directors, officers and employees with respect to options granted to them under the Share Option Plan (2004). As of February 28, 2013, we have granted a total of 1,036,000 options under the Share Option Plan (2004), of which (i) 200,000 options were granted to Mr. Avi Eizenman, such that (a) 30,000 at an exercise price of \$2.53 and at a termination date of December 30, 2014; (b) 40,000 expired in July 2008, (c) 40,000 at an exercise price of \$3.82 and at a termination date of the earlier to occur of October 15, 2016 or the closing price of our shares falling below \$1.91, (d) 50,000 at an exercise price of \$18.82 and at a termination date of the earlier to occur of December 21, 2018 or the closing price of our shares falling below \$9.41 and (e) 40,000 at an exercise price of \$15.28 and at a termination date of the earlier to occur of September 13, 2020 or the closing price of our shares falling below \$7.64, (ii) 30,000 options were granted to Mr. Yehuda Zisapel, (who was formerly a director of the Company) at an exercise price of \$2.53 and at a termination date of December 30, 2014, (iii) 200,000 options were granted to Mr. Shaikhe Orbach, such that (a) 30,000 at an exercise price of \$2.53 and at a termination date of December 30, 2014, (b) 40,000 expired in July 2008, (c) 40,000 at an exercise price of \$3.82 and at a termination date of the earlier to occur of October 15, 2016 or the closing price of our shares falling below \$1.91, (d) 50,000 at an exercise price of \$18.82 and at a termination date of the earlier to occur of December 21, 2018 or the closing price of our shares falling below \$9.41 and (e) 40,000 at an exercise price of \$15.28 and at a termination date of the earlier to occur of September 13, 2020 or the closing price of our shares falling below \$7.64, (iv) 30,000 options were granted to Ms. Einat Domb-Har at an exercise price of \$2.53 and at a termination date of December 30, 2014 ; and (v) 30,000 options were granted to Mr. Ilan Kalmanovich, our former external director, at an exercise price of \$2.53 and at a termination date of December 30, 2014. 25,500 of the options granted under the Share Option Plan (2004) were returned to the company due to certain employees who left their positions not exercising their options and 200,000 of the options granted under the Share Option Plan (2004) expired without exercise due to the expiration of their term.

#### C. Board Practices

Each of Zohar Zisapel, Avi Eizenman and Shaikhe Orbach was elected to the board of directors most recently on April 11, 2012 to serve until the next Annual Shareholders' Meeting, which is scheduled for April 14, 2013. Messrs. Zohar Zisapel and Avi Eizenman are both founders of the Company, and Avi Eizenman has served as a Director since our inception in 1987. In 2004 Ms. Einat Domb-Har and Mr. Ilan Kalmanovich were elected to the board of directors to hold office as external directors for a period of three years in accordance with Section 245(a) of the Israeli Companies Law. In 2007 the appointments of each of Ms. Einat Domb-Har and Mr. Ilan Kalmanovich as external directors were extended for additional three-year terms. On July 1, 2010, the terms of service of Mr. Ilan Kalmanovich and Ms. Einat Domb-Har as external directors in the Company expired. The shareholders of the company extended the appointment of Ms. Einat Domb-Har as external director for a third three-year term, while Mr. Ilan Erez was elected as a new external director for an initial term of three years, with such terms ending as of July 1, 2013. At the next Annual Shareholders Meeting of the Company to be held on April 14, 2013, the shareholders have been asked to re-elect Mr. Ilan Erez as an external director for an additional second three-year term and to elect Ms. Ayelet Aya Hayak as an external director for an initial three-year term, with such terms of office for the external directors commencing as of July 1, 2013. Ms. Hayak will be replacing Ms. Einat Domb-Har who will complete her third and final three-year term as an external director as of July 1, 2013.



None of the members of the board of directors is entitled to receive any severance or similar benefits upon termination of his or her service with the board of directors, except for Avi Eizenman, who also functions as the active Chairman of the board and Shaiké Orbach, who also functions as President and Chief Executive Officer (See “Item 6. Directors and Senior Management – Compensation” above).

In December 2007 our Audit Committee and Board of Directors approved severance arrangements for each of Mr. Avi Eizenman and Mr. Shaiké Orbach, which provide for extended notice provisions and severance payments in the event of termination. The arrangements were approved by our shareholders in January 2008, and include the following main terms and conditions (identical with respect to each of Mr. Avi Eizenman and Mr. Shaiké Orbach):

#### Notice of Termination

The termination of the executive’s employment, by him or by us, for any reason other than cause (which is generally defined as willful conduct or omission materially injurious to the company), death or disability, shall require 12 months advance written notice. If, however, following a change in control transaction, either: (i) he shall give notice of termination of his employment for good reason (which is generally defined as an adverse change to the status, responsibilities, salary or other material terms of his employment); or (ii) we shall give notice of termination of his employment for any reason other than cause or disability, 18 months advance written notice shall be required. A change in control transaction includes transactions such as sale of all or substantially all of the company’s shares or assets, or a merger, acquisition, or other reorganization in which control of our company changes following such transaction.

#### Severance Payments

If the executive’s employment shall be terminated for any reason other than cause, he shall be entitled to receive his last full monthly salary multiplied by the number of years (or portions thereof) that he was employed by us (i.e. the severance amount he would be entitled to receive under the Israeli law, had we terminated his employment for any reason other than cause) (the “Severance Law Amount”). If, however, his employment shall be terminated: (i) by the company for any reason other than cause or disability; or (ii) by him for a good reason following a change in control, he shall be entitled to receive one and half times the Severance Law Amount. If the executive’s employment under the arrangement is terminated by reason of death or disability, then, in addition to the above, he shall be entitled to receive a lump sum severance payment equal to his last full monthly salary multiplied by twelve 12 months.

## Board of Directors

Our Articles of Association provide for a board of directors of not less than two nor more than eight members. Each director (except external directors) is elected to serve until the next annual general meeting of shareholders and until his or her successor has been elected. Officers serve at the discretion of the board of directors. The Articles of Association of the Company provide that any director may, subject to the provisions of the Israeli Companies Law-1999 and the approval by the Board of Directors, appoint another person to serve as a substitute director and may cancel such appointment. Under the Israeli Companies Law-1999, a person who is already serving as a director will not be permitted to act as a substitute director. Additionally, the Israeli Companies Law-1999 prohibits a person from serving as a substitute director for more than one director. Appointment of a substitute director for a member of a board committee is only permitted if the substitute is a member of the board of directors and does not already serve as a member of such committee. If the committee member being substituted is an external director, the substitute may only be another external director who possesses the same expertise as the external director being substituted. The term of appointment of a substitute director may be for one meeting of the board of directors or for a specified period or until notice is given of the cancellation of the appointment. To our knowledge, no director currently intends to appoint any other person as a substitute director, except if the director is unable to attend a meeting of the board of directors.

## External Directors

Under the Israeli Companies Law-1999, companies registered under the laws of Israel the shares of which have been offered to the public in or outside of Israel are required to appoint no less than two external directors. No person may be appointed as an external director if such person is a relative (as defined in the Israeli Companies Law) of a controlling shareholder or if such person, or the person's relative, partner, employer or any entity under the person's control, has or had, on or within the two years preceding the date of the person's appointment to serve as external director, any affiliation with any of either the company, any entity or person controlling, controlled by or under common control with the company, or relatives of such person. The term "affiliation" includes:

- an employment relationship;
- a business or professional relationship maintained on a regular basis;
  - control; and
- service as an office holder.

If the company does not have a controlling shareholder or a shareholder who holds company shares entitling him to vote at least 25% of the votes in a shareholders meeting, then the company may not appoint as an external director any person or such person's relative, partner, employer or any entity under the person's control, who has or had, on or within the two years preceding the date of the person's appointment to serve as external director, any affiliation with the Chairman of the Board, Chief Executive Officer, a substantial shareholder who holds at least 5% of the issued and outstanding shares of the company or voting rights which entitle him to vote at least 5% of the votes in a shareholders meeting, or the Chief Financial Officer.

A person shall be qualified to serve as an external director only if he or she possesses “expertise in finance and accounting” or “professional qualifications”. At least one external director must possess expertise in finance and accounting.

A director can satisfy the requirements of having “expertise in finance and accounting” if due to his or her education, experience and qualifications he or she has acquired expertise and understanding in business and accounting matters and financial statements, in a manner that allows him or her to understand, in depth, the company’s financial statements and to spur a discussion regarding the manner in which the financial data is presented.

A public company's board of directors must evaluate the proposed external director's expertise in finance and accounting, by considering, among other things, such candidate’s education, experience and knowledge in the following: (i) accounting and auditing issues typical to the field in which the company operates and to companies of a size and complexity similar to such company; (ii) the company's independent public accountant’s duties and obligations; (iii) preparation of the company’s consolidated financial statements and their approval in accordance with the Companies Law and the Israeli Securities Law - 1961.

A director is deemed to be “professionally qualified” if he or she meets any of the following criteria: (i) has an academic degree in any of the following professions: economics, business administration, accounting, law or public administration; (ii) has a different academic degree or has completed higher education in a field that is the company’s main field of operations, or a field relevant to his or her position; or (iii) has at least five years experience in any two of the following: (A) a senior position in the business management of a corporation with a significant extent of business, (B) a senior public position or a senior position in public service, or (C) a senior position in the company's main field of operations. As with a candidate’s expertise in finance and accounting, the board of directors here too must evaluate the proposed external director's "professional qualification" in accordance with the criteria set forth above.

The declaration required by law to be signed by a candidate to serve as an external director must include a statement by such candidate concerning his or her education and experience, if relevant, in order that the board of directors may properly evaluate whether such candidate meets the requirements of having "expertise in finance and accounting" or being "professionally qualified" as set forth in the regulations. Additionally, the candidate should submit documents and certificates that support the statements set forth in the declaration.

No person may serve as an external director if the person’s position or other business activities create, or may create, a conflict of interest with the person’s responsibilities as an external director or may otherwise interfere with the person’s ability to serve as an external director. Additionally, no person may serve as an external director if the person, the person’s relative, spouse, employer or any entity controlling or controlled by the person, has a business or professional relationship with someone with whom affiliation is prohibited, even if such relationship is not maintained on a regular basis, excepting negligible relationships, or if such person received from the company any compensation as an external director in excess of what is permitted by the Israeli Companies Law. If, at the time external directors are to be appointed, all current members of the board of directors who are not controlling shareholders or relatives of such shareholders are of the same gender, then at least one external director must be of the other gender.



External directors are to be elected by a majority vote at a shareholders' meeting, provided that either:

- the majority includes at least one half of the shares held by non-controlling and disinterested shareholders who are present and voting at the meeting; or
- the total number of shares held by non-controlling and disinterested shareholders that voted against the election of the director does not exceed two percent of the aggregate voting rights in the company.

Under the Companies Law, the initial term of an external director is three years, and generally may be extended for up to two additional three year terms (unless otherwise restricted in the articles of association to only one additional term), subject to certain conditions (which can also depend on whether the external director was nominated by the board of directors or by the shareholders). External directors may be removed only by the same percentage of shareholders as is required for their election, or by a court, and then only if the external directors cease to meet the statutory qualifications for their appointment, violate their duty of loyalty to the company or are found by a court to be unable to perform their duties on a full time basis. External directors may also be removed by an Israeli court if they are found guilty of bribery, fraud, administrative offenses in a company or use of inside information. Each committee of a company's board of directors which has been granted any authority normally reserved for 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 Israeli Companies Law-1999 and is otherwise prohibited from receiving any other compensation, directly or indirectly, in connection with service provided as an external director. In 2004 Ms. Einat Domb-Har and Mr. Ilan Kalmanovich were elected to the board of directors of the Company to hold office as external directors for a period of three years in accordance with Section 245(a) of the Companies Law – 1999. In 2007 the appointments of each of Ms. Einat Domb-Har and Mr. Ilan Kalmanovich as external directors were extended for additional three-year terms. On July 1, 2010, the terms of service of Mr. Ilan Kalmanovich and Ms. Einat Domb-Har as external directors in the Company expired. The shareholders of the company extended the appointment of Ms. Einat Domb-Har as external director for a third three-year term, while Mr. Ilan Erez was elected as a new external director for an initial term of three years, with such terms ending as of July 1, 2013. At the next Annual Shareholders Meeting of the Company to be held on April 14, 2013, the shareholders of the Company have been asked to re-elect Mr. Ilan Erez as an external director for second three-year term and to elect Ms. Ayelet Aya Hayak as an external director for an initial three-year term, with such terms of office for the external directors commencing as of July 1, 2013. Ms Hayak will be replacing Ms. Einat Domb-Har who will complete her third and final three-year term as an external director of the Company as of July 1, 2013.

## Audit Committee

The Israeli Companies Law- 1999 requires public companies to appoint an audit committee. The responsibilities of the audit committee pursuant to the Companies Law include identifying irregularities in the management of our business and approving related party transactions as required by law, classifying company transactions as extraordinary transactions or non-extraordinary transactions and as material or non-material transactions in which an officer has an interest (which will have the effect of determining the kind of corporate approvals required for such transaction), assessing the proper function of the company's internal audit regime and determining whether its internal auditor has the requisite tools and resources required to perform his role and to regulate the company's rules on employee complaints, reviewing the scope of work of the company's independent accountants and their fees, and implementing a whistleblower protection plan with respect to employee complaints of business irregularities. An audit committee must consist of at least three directors, including all the external directors of the company, and a majority of the members of the audit committee must be independent or external directors. The Companies Law defines independent directors as either external directors or directors who: (1) meet the requirements of an external director, other than the requirement to possess accounting and financial expertise or professional qualifications, with Audit Committee confirmation of such; (2) have been directors in the company for an uninterrupted duration of less than 9 years (and any interim period during which such person was not a director which is less than 2 years shall not be deemed to interrupt the duration); and, (3) were classified as such by the company.

The following persons may not be a member of the audit committee:

- The chairman of the board of directors,
- Any director employed by or otherwise providing services to the company or to the controlling shareholder or entity under such controlling shareholder's control,
  - Any director who derives his salary primarily from a controlling shareholder,
    - A controlling shareholder, or
    - Any relative of a controlling shareholder.

According to the Companies Law, (1) the chairman of the audit committee must be an external director, (2) the required quorum for audit committee meetings and decisions is a majority of the committee members, of which the majority of members present must be independent and external directors, and (3) any person who is not eligible to serve on the audit committee is further restricted from participating in its meetings and votes, unless the chairman of the audit committee determines that such person's presence is necessary in order to present a certain matter, provided however, that company employees who are not controlling shareholders or relatives of such shareholders may be present in the meetings but not for the actual votes, and likewise, company counsel and company secretary who are not controlling shareholders or relatives of such shareholders may be present in the meetings and for the decisions if such presence is requested by the audit committee.

Currently, Ms. Einat Domb-Har, Mr. Ilan Erez and Mr. Zohar Zisapel serve as members of our audit committee, and Ms. Domb-Har serves as the chairperson.

#### Compensation Committee

On December 5, 2010, our board of directors established a compensation committee, composed of at least two directors who were initially Mr. Zohar Zisapel, as chairman, and Mr. Avi Eizenman. Such Committee did not have the authority to approve resolutions and take action in lieu of the board of directors, and its sole function was to recommend to the board of directors with respect to the certain executive compensation matters and any other matters as the board of directors decided from time to time.

In December 2012, the recently adopted Amendment 20 to the Israeli Companies Law-1999 (“Amendment 20”) went into effect. Amendment 20 requires, amongst other provisions, that the Board of Directors of Israeli publicly traded Companies appoint a compensation committee comprised of at least three members, that all External Directors be members of the compensation committee who must also comprise a majority of the members of the compensation committee, and that the chairman of the compensation committee be an External Director. The following persons may not be a member of the compensation committee:

- The chairman of the board of directors,
- Any director employed by or otherwise providing services to the company or to the controlling shareholder or entity under such controlling shareholder's control,
  - Any director who derives his salary primarily from a controlling shareholder,
    - A controlling shareholder, or
    - Any relative of a controlling shareholder.

The responsibilities of the compensation committee include the following:

1. To recommend to the Board of Directors as to a compensation policy for officers of the company, as well as to recommend, once every three years to extend the compensation policy subject to receipt of the required corporate approvals;
2. To recommend to the Board of Directors as to any updates to the compensation policy which may be required;
3. To review the implementation of the compensation policy by the Company;
4. To approve transactions relating to terms of office and employment of certain Company office holders, which require the approval of the compensation committee pursuant to the Companies Law; and
5. To exempt, under certain circumstances, a transaction relating to terms of office and employment from the requirement of approval of the shareholders meeting.

In December 2012, our Board of Directors changed the composition of the members of the compensation committee by removing Mr. Avi Eizenman from the compensation committee, and appointing the Company's two External Directors, Mr. Ilan Erez and Ms. Einat Domb-Har to the compensation committee, and appointing Mr. Ilan Erez as chairman of the compensation committee. The compensation committee has been charged by the Board of Directors to act in accordance with the powers and prerogatives delegated to it by the Israeli Companies Law-1999 and take any decisions and make any recommendations to the Board all as set forth in the Israeli Companies Law-1999.

Under Amendment 20, a board of directors of an Israeli publicly traded company, following the advisement of the compensation committee, is required to establish a compensation policy, to be approved by the shareholders of the company, and pursuant to which the terms of office and compensation of the company's officer holders will be decided.

Under Section 267B(a) and Parts A and B of Annex 1A of the Companies Law, which were legislated as part of Amendment 20, a company's compensation policy shall be determined based on, and take into account, the following parameters:

- a. advancement of the goals of the Company, its working plan and its long term policy;
- b. the creation of proper incentives for the office holders while taking into consideration, inter alia, the Company's risk management policies;
- c. the Company's size and nature of its operations;
- d. the contributions of the relevant office holders in achieving the goals of the Company and profit in the long term in light of their positions;
- e. the education, skills, expertise and achievements of the relevant office holders;
- f. the role of the office holders, areas of their responsibilities and previous agreements with them;
- g. the correlation of the proposed compensation with the compensation of other employees of the Company, and the effect of such differences in compensation on the employment relations in the company; and
- h. the long term performance of the office holder.

In addition, the compensation policy should take into account that in the event the compensation paid to office holders shall include variable components – it should allow for the ability of the board of directors to reduce the value of the variable component from time to time or to set a cap on the exercise value of convertible securities components that are not paid out in cash. Additionally, in the event that the terms of office and employment include grants or payments made upon termination – such grants should take into consideration the length of the term of office or period of employment, the terms of employment of the office holder during such period, the company’s success during said period and the office holder’s contribution to obtaining the company’s goals and maximizing its profits as well as the circumstances and context of the termination.

In addition, the compensation policy must set forth standards and rules on the following issues: (a) with respect to variable components of compensation - basing the compensation on long term performance and measurable criteria (though an insubstantial portion of the variable components can be discretion based awards taking into account the contribution of the officer holder to the company); (b) establishing the appropriate ratio between variable components and fixed components and placing a cap on such variable components; (c) setting forth a rule requiring an office holder to return amounts paid, in the event that it is later revealed that such amounts were paid on the basis of data which prove to be erroneous and resulted in an amendment and restatement of the company’s financial statements; (d) determining minimum holding or vesting periods for equity based variable components of compensation, while taking into consideration appropriate long term incentives; and (e) setting a cap on grants or benefits paid upon termination

The board of directors of a company is obligated to adopt a compensation policy after considering the recommendations of the compensation committee. The final adoption of the compensation committee is subject to the approval of the shareholders of the company, which such approval is subject to certain special majority requirements, as set forth in Amendment 20, pursuant to which one of the following must be met:

- (i) the majority of the votes includes at least a majority of all the votes of shareholders who are not controlling shareholders of the company or who do not have a personal interest in the compensation policy and participating in the vote; abstentions shall not be included in the total of the votes of the aforesaid shareholders; or
- (ii) the total of opposing votes from among the shareholders described in subsection (i) above does not exceed 2% of all the voting rights in the company.

Nonetheless, even if the shareholders of the company do not approve the compensation policy, the board of directors of a company may approve the compensation policy, provided that the compensation committee and, thereafter, the board of directors determined, based on detailed, documented, reasons and after a second review of the compensation policy, that the approval of the compensation policy is for the benefit of the company.

Israeli companies whose shares or debt instruments are publicly traded are required to comply with the requirements of Amendment 20 and to adopt a compensation policy by no later than September 12, 2013. Until such time that a company adopts a compensation policy, compensation of office holders must be approved in accordance with transition rules set forth in Amendment 20 which apply to the approval of officer compensation prior to the adoption and approval of a compensation policy by a company.

Our compensation committee and Board of Directors are currently reviewing the compensation of office holders at the Company, with the aim of preparing and approving a compensation policy applicable to all office holders of the Company, and bringing such policy for approval of the shareholders prior to September 2013 as required under Amendment 20. Until such time, management seeks corporate approvals for office holder compensation in accordance with the transition rules set forth under Amendment 20 as applicable to the particular office holder and/or the proposed compensation.

#### Internal Auditor

Under the Israeli Companies Law-1999, the board of directors of a public company must appoint an internal auditor, who is nominated by the audit committee. The role of the internal auditor is to examine, among other matters, whether our actions comply with the law and orderly business procedure. Under the Israeli Companies Law-1999, the internal auditor may be an employee of the company but not an office holder (as defined in Item 10 below), nor an affiliate, nor a relative of an office holder or affiliate, and he or she may not be our independent accountant or its representative. Doron Cohen of Fahn Kaneh Control Management Ltd. (a subsidiary of Fahn Kanne & Co. - Grant Thornton Israel) serves as our internal auditor.

#### D. Employees

The number of employees over the last three financial years is set forth in the table below.

As of December 31	2010	2011	2012
Total Employees	85	96	111
Marketing, Sales, Customer Services	10	12	14
Research & Development	30	31	37
Manufacturing	37	44	51
Corporate Operations and Administration	8	9	9

As of February 28, 2013, we had 113 employees, including 15 in marketing, sales and customer services, 38 in research and development, 51 in manufacturing, and 9 in corporate operations and administration. All such employees, except for 2 employees in the United States, are based in Israel. We consider our relations with our employees excellent and have never experienced a labor dispute, strike or work stoppage. None of our employees is represented by a labor union. We do not employ a significant number of temporary employees, but we do use temporary employees from time to time, as necessary.

In Israel we are subject to certain labor statutes and national labor court precedent rulings, as well as to 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 Industrialists' Associations. These provisions of collective bargaining agreements are applicable to our Israeli employees by virtue of expansion orders issued in accordance with relevant labor laws by the Israeli Ministry of Labor and Welfare, and which apply such agreement provisions to our employees even though they are not directly part of a union that has signed a collective bargaining agreement. The laws and labor court rulings that apply to our employees principally concern the minimum wage laws, procedures for dismissing employees, determination of severance pay, leaves of absence (such as annual vacation or maternity leave), sick pay and other conditions for employment. The expansion orders which apply to our employees principally concern the requirement for length of the work day and workweek, mandatory contributions to a pension fund, annual recreation allowance, travel expenses payment and other conditions of employment. We generally provide our employees with benefits and working conditions beyond the required minimums.

Israeli law generally requires severance pay, which may be funded by managers' insurance and/or a pension fund described below, upon the retirement or death of an employee or termination of employment without cause (as defined in the law). The payments to the managers' insurance and/or pension fund in respect of severance pay amount to approximately 8.33% of an employee's wages, in the aggregate. Furthermore, Israeli employees and employers are required to pay predetermined sums to the National Insurance Institute, which is similar to the United States Social Security Administration. Such amounts also include payments for national health insurance. The payments to the National Insurance Institute are equal to approximately 16% of an employee's wages, of which the employee contributes approximately 62.5% and the employer contributes approximately 37.5%.

A general practice followed by us, is the contribution of funds on behalf of most of its employees either to a fund known as managers' insurance or to a pension fund, or to a combination of both. Such practice was further reinforced in July 1, 2008, when we entered into agreements with a majority of its employees in order to implement Section 14 to the Severance Pay Law, according to which the payment of monthly deposits by us into managers' insurance and/or pension fund are in respect of severance obligation to such employees. See Note 9 of our consolidated financial statements. These funds provide a combination of savings plan, insurance and severance pay benefits to the employee, giving the employee a lump sum payment upon retirement and securing the severance pay or part of it, if legally entitled, upon termination of employment. Each employee contributes an aggregate amount equal to between 5% and 5.5% of his base salary to such funds, and we contribute, in the aggregate, between 13.3% and 15.8% of the employee's base salary, with such amount including the 8.33% which is contributed as severance pay as noted above.

## E. Share Ownership

The following table sets forth, as of February 28, 2013, the number of Shares owned by our officers, directors and senior management. The percentages shown are based on 7,085,964 shares outstanding as of February 28, 2013:

Name and Address	Number of Shares and Options Owned <sup>1</sup>	Percent of Outstanding Shares	
Zohar Zisapel <sup>2</sup>	1,511,722	21.33	%
Avi Eizenmann	216,528	3.04	%
Shaika Orbach	*	*	
Einat Domb Har	*	*	
Ayelet Aya Hayak	*	*	
Ilan Erez	*	*	
Eran Gilad	*	*	
All directors and officers as a group	1,728,250	24.30	%

\* Denotes ownership of less than 1% of the outstanding shares.

1 The table above includes the number of shares and options that are exercisable within 60 days of February 28, 2013. Ordinary shares subject to these options are deemed beneficially owned for the purpose of computing the ownership percentage of the person or group holding these options, but are not deemed outstanding for purposes of computing the ownership percentage of any other person. Except where otherwise indicated, and subject to applicable community property laws, based on information furnished to us by such owners or otherwise disclosed in any public filings, to our knowledge, the persons and entities named in the table have sole voting and dispositive power with respect to all shares shown as beneficially owned by them.

2 Based on Schedule 13D/A filed on March 5, 2009.

See also “Item 6. Directors and Senior Management – Compensation.”

## Item 7. MAJOR SHAREHOLDERS AND RELATED PARTY TRANSACTIONS

## A. Major Shareholders

The shareholders of the Company who beneficially own over 5% or more of each class of shares, as well as the number of shares owned and the percentage of outstanding shares owned by each, and additional information, is set forth below. The voting rights of our major shareholders do not differ from the voting rights of other holders of our ordinary shares. All of the information with respect to beneficial ownership of the Ordinary Shares is given to the best of our knowledge.



Name of Shareholder	Number of Shares and Options Owned <sup>1</sup>	Percentage of Outstanding Shares	
Zohar Zisapel <sup>2</sup>	1,511,722	21.33	%
Wellington Management Company, LLP <sup>3</sup>	542,577	7.66	%
Yelin Lapidot Holdings Management Ltd. <sup>4</sup>	478,674	6.76	%

1 The table above includes the number of shares and options that are exercisable within 60 days of February 28, 2013. Ordinary shares subject to these options are deemed beneficially owned for the purpose of computing the ownership percentage of the person or group holding these options, but are not deemed outstanding for purposes of computing the ownership percentage of any other person. Except where otherwise indicated, and subject to applicable community property laws, based on information furnished to us by such owners or otherwise disclosed in any public filings, to our knowledge, the persons and entities named in the table have sole voting and dispositive power with respect to all shares shown as beneficially owned by them.

2 Based on Schedule 13D/A filed on March 5, 2009.

3 As reported on the Schedules 13G filed by each of Wellington Management Company, LLP (“Wellington Management”) and Wellington Trust Company, NA (“Wellington Trust”, and collectively with Wellington Management, “Wellington”) with the Securities and Exchange Commission on February 14, 2013, Wellington in its capacity as investment adviser may be deemed to beneficially own 542,577 Ordinary Shares of the Company, and has shared power to vote and dispose of (or to direct such actions) such Ordinary Shares. Wellington has reported that it filed the Schedules 13G in its capacity as investment adviser, and the Ordinary Shares of the Company are owned of record by clients of Wellington, who have the right to receive, or the power to direct the receipt of, dividends from, or the proceeds from the sale of, such Ordinary Shares, and that no such client of Wellington is known to have such right or power with respect to more than five percent of the Ordinary Shares of the Company. Based on public filings on Form 13F, Wellington’s holdings in our Ordinary Shares have increased from 151,500 as reported on Form 13F in May 2011 to the amount set forth above.

4 As reported by Yelin Lapidot Holdings Management Ltd., an Israeli investment management firm (“Yelin Lapidot”), in correspondence with the Company, the most recent of which was dated February 28, 2013, all 478,674 Ordinary Shares of the Company are beneficially owned by Yelin Lapidot via two of its subsidiaries, Yelin Lapidot Provident Funds Management Ltd. which holds 206,309 Ordinary Shares of the Company, and Yelin Lapidot – Mutual Funds Management Ltd. which holds 272,365 Ordinary Shares of the Company.

As of February 28, 2013, there were approximately 10 record holders of ordinary shares, including approximately 7 record holders in the United States. Collectively, these 7 record holders in the United States held approximately 1% of the outstanding ordinary shares.

B. Related Party Transactions

Messrs. Yehuda and Zohar Zisapel are brothers and are our founders. On July 15, 2010 Mr. Yehuda Zisapel resigned from serving as director on our board of directors, and on September 2, 2010, Mr. Zohar Zisapel was appointed as a director on our board. Messrs. Yehuda and Zohar Zisapel are also founders, directors and principal shareholders of several other corporations within the “Rad Group”, as described in “Item 6. Directors, Senior Management and Employees”.

There are other members of the Rad Group that are actively engaged in designing, manufacturing, marketing and supporting data communications products, none of which are currently the same as our products. Certain products of members of the Rad Group are complementary to, and may be used in connection with, our products. We and other members of the Rad Group also market certain of our products through the same distribution channels. Such products may, to a limited extent, compete with one another for the distributors’ time and efforts.

The Rad Group provides us with certain services, and is reimbursed by us for the costs of providing such services. During 2012, we purchased from the Rad Group internet services for an amount of up to \$42,000, testing services for our products for an amount of up to \$89,000 and car leasing services for an amount of up to \$4,000. We also sub-lease office space in Paramus, New Jersey, for an amount of up to \$12,000 (monthly rent payments of approximately \$1,000) from Radcom Equipmet, Inc., an affiliated company of the Rad Group. We began to sub-lease this space in February 2004; the sub-lease was in effect until January 31, 2006 and was renewed for additional one-year periods through January 31, 2013. On January 1, 2013, we extended the sub-lease for an additional one-year period until December 31, 2013.

During 2012, we sold external bypass switches and Server Adapters to members of the Rad Group for an amount of approximately \$558,000.

The material terms of the arrangements with the Rad Group, described in the preceding paragraphs, occur within the Company's ordinary course of business, and on market terms. We believe that such arrangements are neither material to us nor unusual in their nature or conditions. We further believe that the terms of the transactions in which we have engaged and are currently engaged with other members of the Rad Group are generally no less favorable to us than terms which might be available to us from unaffiliated third parties.

In January 2006 our board of directors approved a resolution under which sales to or purchases from any members of the Rad Group must meet certain criteria or otherwise be specifically approved by the relevant corporate bodies, as applicable in accordance with Israeli law. These criteria included a stipulation that transactions between us and members of the Rad Group relate to standard equipment, services and products purchased or sold by us and the Rad Group, as applicable, and that such transactions occur within our ordinary course of business. The January 2006 resolution determined that transactions with members of the Rad Group must be entered into at least on market terms and at a value lower than 0.5% of our annual turnover per transaction and not more than 1% of our annual turnover in the aggregate for all such transactions in a financial year. Further, all future related party transactions and arrangements (or modifications of existing ones) with members of the Rad Group, transactions in which office holders of the Company have a personal interest, or transactions which raise issues of such office holders’ fiduciary duties, could require additional corporate approvals as applicable under the Israeli Companies Law-1999.

In January 2011, recognizing that sales to or purchases from the Rad Group may in the aggregate exceed 1% of our annual turnover in such year (without constituting extraordinary transactions as defined in the Israeli Companies Law), our board of directors revised its January 2006 resolution in respect of related party transactions.

In its new resolution, on January 23, 2011, the board of directors approved sales to or purchases from the Rad Group, from time to time, of standard equipment, services and products, which are (i) within our ordinary course of business and (ii) at least at market terms and at a value lower than 0.5% of our annual turnover per transaction and 2.5% of our annual turnover for all such transactions in a financial year, aggregated together. Our management is required to examine on a quarterly basis whether transactions with the Rad Group comply with such criteria. Transactions which do not meet the criteria will require specific corporate approvals in the applicable manner prescribed by Israeli law

Our board of directors further determined that our transactions with the Rad Group during 2010, which constituted 1.2% of our annual turnover, were (i) within our ordinary course of business; (ii) at least at market terms and at a value lower than 0.5% of our annual turnover per transaction and (iii) did not have any material effect on our profitability, assets or obligations.

In addition to being a founder, director and principal shareholder of each member of the Rad Group, Yehuda Zisapel is the founder and principal shareholder of Bynet and its subsidiaries. Bynet acts as a distributor in Israel for us and for other members of the Rad Group and also acts as a distributor in Israel for numerous unaffiliated manufacturers of data communications and other equipment. We believe that the terms of our relationship with Bynet are generally no less favorable to us than terms which might be available to us from unaffiliated third parties.

Except as indicated above, we do not directly currently compete with other members of the Rad Group and do not currently contemplate engaging in competition with any other member of the Rad Group in the future. However, opportunities to develop, manufacture or sell new products (or otherwise enter new fields) may arise in the future, which opportunities might be pursued by us or by one or more other members of the Rad Group to the exclusion of (or in competition with) other members of the Rad Group (including us). In the event that any such opportunity arises, the directors then in office will determine whether or not we should seek to pursue it. Any such determination will be based upon such factors as the directors then deem relevant. However, in making any such determination, the directors will be bound by their fiduciary duties to the Company (and to any other corporation or other person to whom they then owe a fiduciary duty).

On July 22, 2002, our audit committee and the Board of Directors approved an Indemnification Agreement with our directors and officers. Our shareholders approved the terms of this agreement in a General and Extraordinary Meeting held on January 7, 2004. In the March 2005 amendment to the Israeli Companies Law-1999, the instances in which a company may indemnify its officers and directors were broadened. In December 2007 each of our audit committee and Board of Directors approved a new form of Indemnification Agreement with our directors and officers so as to reflect this amendment. Our shareholders approved the terms of this new Indemnification Agreement in January 2008. An amendment in 2011 to the Israeli Securities Law, 5728-1968 (the "Israeli Securities Law"), and a corresponding amendment to the Companies Law, authorizes the Israeli Securities Authority to impose administrative sanctions against companies like Silicom Ltd. and their office holders for certain violations of the Israeli Securities Law or the Companies Law. These sanctions include monetary sanctions and certain restrictions on serving as a director or senior officer of a public company for certain periods of time. The amendments to the Israeli Securities Law and to the Companies Law provide that only certain types of such liabilities may be reimbursed by indemnification and insurance. Specifically, legal expenses (including attorneys' fees) incurred by an individual in the applicable administrative enforcement proceeding and certain compensation payable to injured parties for damages suffered by them are permitted to be reimbursed via indemnification or insurance, provided that such indemnification and insurance are authorized by the company's articles of association, and receive the requisite corporate approvals. In January 2012 each of our audit committee and Board of Directors approved a new form of Indemnification Agreement with our directors and officers so as to reflect this amendment, and our shareholders approved these amendments to the Articles of Association and a revised form of Indemnification Agreement for directors at the Annual General Meeting of the Shareholders held on April 11, 2012.

The Indemnification Agreement provides that our directors and officers will be exempt from liability in certain circumstances. The Indemnification Agreement also provides for the indemnification by the Company for certain obligations and expenses imposed on the officer in connection with act performed in his or her capacity as an officer of the Company. This right to indemnification is limited, and does not cover, among other things, a breach of an officer's duty of loyalty, a willful breach of an officer's duty of care, or a reckless disregard for the circumstances or consequences of a breach of a duty of care. The right to indemnification also does not cover acts that are taken intentionally to unlawfully realize personal gain. The maximum amount of our liability under these Indemnification Agreements for any monetary obligation imposed on an officer or a director in favor of another person by a judgment is currently \$3,000,000 for each instance of a covered scenario. In addition we would be liable to indemnify the officer or director for all reasonable litigation expenses with respect to certain proceedings.

We have maintained liability insurance for our directors and officers. On September 23, 2007 our shareholders approved the procurement of a policy, which provides for total coverage of up to \$4,000,000. All of our directors are parties to our Indemnification Agreements and are covered by our directors and officers insurance policy.

See also “Item 6. Directors and Senior Management – Compensation.”

## Item 8. FINANCIAL INFORMATION

### A. Consolidated Statements and Other Financial Information

Our consolidated financial statements and other financial information are included herein on pages F-1 through F-37.

A1. See Item 18 for our consolidated financial statements.

A2. See Item 18 for our consolidated financial statements, which cover the last three financial years.

A3. See page F-2 for the audit report of our accountants, entitled “Report of Independent Registered Public Accounting Firm.”

A4. Not applicable.

A5. Not applicable.

A6. See Note 10(A.) to our audited consolidated financial statements included in Item 18 of this annual report for the geographic distribution of our sales based on the location of the customer.

### A7. Litigation

On March 2, 2012 Internet Machines LLC, a Texas limited liability company filed a patent infringement lawsuit in the United States District Court for the Eastern District of Texas (the “Court”) against numerous defendants (including many switch manufacturers) with respect to certain patents for switches, and included our US subsidiary amongst the list of defendants named in such lawsuit. The lawsuit claims that the defendants have infringed certain patents purported to be owned by Internet Machines LLC and seeks unspecified compensation for damages as well as injunctive relief. The defendants filed answers and counterclaims to the complaint asserting that they do not infringe any claims of the asserted patents and the claims of the patents are invalid and/or unenforceable. While one of our switch suppliers (which is also named as a defendant in the aforesaid lawsuit) has agreed to indemnify us with respect to certain liabilities, there is no certainty that we will ultimately be able to collect all or any amounts under such indemnity should we be found liable under the lawsuit. On September 4, 2012, the Court granted the defendants' motion to stay the pending litigation.

Other than the above, we are not a party to any material litigation and we are not aware of any pending or threatened litigation that would have a material adverse effect on us or our business.

#### A8. Dividend Policy

We have not paid dividends in the past. On January 14, 2013, we announced that our Board of Directors has adopted a policy for distributing dividends, subject to all applicable laws. According to this policy, each year we will distribute a dividend of up to 50% of our annual distributable profits. As part of the stated policy, the Company's Board of Directors reserves the right to declare additional dividend distributions, to change the rate of dividend distributions (either as a policy or on a one-time basis), to cancel a specific distribution or to cancel the policy as a whole at any time, at its sole discretion. The actual distribution of a dividend will be subject to meeting the conditions required by applicable law, including the distribution tests set forth in Section 302 of the Israeli Companies Law - 1999, and to the specific decision of the Company's Board of Directors for each distribution. Future dividend policy will be reviewed by the Board of Directors based upon conditions then existing, including our earnings, financial condition, capital requirements and other factors. Our ability to pay cash dividends may be restricted by instruments governing any of our obligations.

Dividends paid by an Israeli company to shareholders residing outside Israel from 2012 and on are generally subject to withholding of Israeli income tax at a rate of up to 25%. Such tax rates apply unless a lower rate is provided in a treaty between Israel and the shareholder's country of residence. In our case, the applicable withholding tax rate will depend on the particular Israeli production facilities that have generated the earnings that are the source of the specific dividend and, accordingly, the applicable rate may change from time to time.

On March 18, 2013 our Board of Directors declared a dividend of US \$0.55 per share payable on April 17, 2013 to shareholders of record as of April 4, 2013, and in the aggregate amount of approximately US \$3.9 million for 2012.

#### B. Significant Changes

Since the date of the annual financial statements included in this Annual Report, no significant changes have occurred.

### Item 9. THE OFFER AND LISTING

#### A. Offer and listing details

##### Markets and Share Price History

The primary trading market for our ordinary shares is the NASDAQ Global Market (previously NASDAQ National Market), where our shares have been listed and traded under the symbol SILC (previously SILCF) since February 11, 2008. Prior thereto, our shares were listed and traded on the NASDAQ Capital Market (previously known as the NASDAQ Small-Cap).

The table below sets forth the high and low reported sales prices in dollars of our ordinary shares, as reported by NASDAQ during the indicated periods:

PERIOD	HIGH	LOW
<b>LAST 6 CALENDAR MONTHS</b>		
February 2013	27.40	22.33
January 2013	25.08	17.97
December 2012	18.05	17.20
November 2012	18.50	16.01
October 2012	18.50	15.15
September 2012	15.70	14.49
<b>FINANCIAL QUARTERS DURING THE PAST TWO YEARS</b>		
Fourth Quarter 2012	18.50	15.15
Third Quarter 2012	15.70	13.59
Second Quarter 2012	17.99	13.11
First Quarter 2012	20.33	15.77
Fourth Quarter 2011	19.33	13.11
Third Quarter 2011	20.75	12.17
Second Quarter 2011	21.91	17.00
First Quarter 2011	21.85	16.00
<b>FIVE MOST RECENT FULL FINANCIAL YEARS</b>		
2012	20.33	13.11
2011	21.91	12.17
2010	19.54	8.02
2009	10.20	4.11
2008	16.75	2.87

On December 27, 2005, our shares commenced trading on the Tel Aviv Stock Exchange in Israel under the symbol “SILC” (in Hebrew letters). The following table sets forth, for the periods indicated, the high and low reported sales prices, in NIS, of the ordinary shares on the Tel Aviv Stock Exchange:

PERIOD	HIGH	LOW
<b>LAST SIX CALENDAR MONTHS</b>		
February 2013	100.80	85.20
January 2013	92.93	66.50
December 2012	71.66	66.00
November 2012	72.77	66.55
October 2012	71.99	58.85
September 2012	62.00	58.18
<b>FINANCIAL QUARTERS DURING THE PAST TWO YEARS</b>		
Fourth Quarter 2012	72.77	58.85
Third Quarter 2012	62.00	53.01
Second Quarter 2012	69.69	51.60
First Quarter 2012	73.00	60.31
Fourth Quarter 2011	69.00	50.50
Third Quarter 2011	70.05	44.16
Second Quarter 2011	72.50	59.82
First Quarter 2011	80.64	55.25
<b>FIVE MOST RECENT FULL FINANCIAL YEARS</b>		
2012	73.00	51.60
2011	80.64	44.16
2010	71.20	30.31
2009	44.44	16.20
2008	59.80	13.05

#### Item 10. ADDITIONAL INFORMATION

##### A. Share Capital

Not applicable

##### B. Memorandum and Articles of Association

###### Articles of Association

Our shareholders approved our Amended and Restated Articles of Association (“Articles”) on January 24, 2008, as well as certain additional amendments to the Articles on April 11, 2012. Our objective as stated in the Articles is to carry on any business and perform any act which is not prohibited by law.



We have currently outstanding only one class of shares, our Ordinary Shares, having a nominal value of NIS 0.01 per share. Holders of Ordinary Shares have one vote per share, and are entitled to participate equally in the payment of dividends and share distributions and, in the event of a liquidation of the Company, in the distribution of assets after satisfaction of liabilities to creditors. No preferred shares are currently authorized.

Our Articles require that we hold our annual general meeting of shareholders each year no later than 15 months from the last annual meeting, at a time and place, either within or without the State of Israel, determined by the board of directors, upon 21 days' prior notice to our shareholders or 35 days' prior notice to the extent required with respect to certain matters as required under the regulations to the Israeli Companies Law-1999 the "Companies Law"). In general, no business may be commenced at a general meeting until a quorum of two or more shareholders holding at least 33 1/3% of the voting rights is present in person or by proxy. Shareholders may vote in person or by proxy.

A simple majority is required to amend the articles of association of a company.

Pursuant to the Israeli Companies Law, resolutions regarding the following matters must be passed at a general meeting of shareholders:

- appointment or termination of our auditors;
- appointment and dismissal of directors;
- approval of interested party acts and transactions requiring general meeting approval as provided in sections 255 and 268 to 275 of the Israeli Companies Law;
  - a merger as provided in section 320(a) of the Israeli Companies Law;
- the exercise of the powers of the board of directors, if the board of directors is unable to exercise its powers and the exercise of any of its powers is vital for our proper management, as provided in section 52(a) of the Israeli Companies Law.

An extraordinary general meeting may be convened by demand of two directors or by written request of one or more shareholders holding at least 5% of our issued share capital and 1% of the voting rights or one or more shareholders holding at least 5% of the voting rights. Shareholders requesting a special meeting must include in their request all relevant information, including the reason that such subject is proposed to be brought before the special meeting.

#### The Israeli Companies Law-1999

We are subject to the provisions of the Israeli Companies Law, which became effective on February 1, 2000. The Israeli Companies Law codifies the fiduciary duties that "office holders," including directors and executive officers, owe to a company. An office holder, as defined in the Israeli Companies Law, is a general manager (also referred to as the "chief executive officer"), chief business manager, deputy general manager, vice general manager, executive Vice-President, Vice-President, any other person assuming the responsibilities of any of the foregoing positions without regard to such person's title, as well as a director, or another manager directly subordinate to the general manager. Each person listed in the table in "Item 6. Directors, Senior Management and Employees" above is an office holder of Silicom.

The Israeli Companies Law requires that an office holder of a company promptly disclose, no later than the first board meeting in which such transaction is discussed, any personal interest that he or she may have and all related material information known to him or her, in connection with any existing or proposed transaction by the company. In addition, if the transaction is an extraordinary transaction, the office holder must also disclose any personal interest held by the office holder's relative (which includes for these purposes any members of his/her (or his/her spouse's) immediate family or the spouses of any such members of his or her (or his/her spouse's) immediate family), or by any corporation in which the office holder or the office holder's relative is a 5% or greater shareholder, holder of 5% or more of the voting power, director or general manager or in which he or she has the right to appoint at least one director or the general manager. An extraordinary transaction is defined as a transaction not in the ordinary course of business, not on market terms, or that is likely to have a material impact on the company's profitability, assets or liabilities.

In the case of a transaction in which an officer holder of the company has a personal interest and which is not an extraordinary transaction, after the office holder complies with the above disclosure requirement, only board approval is required unless the articles of association of the company provide otherwise. The transaction must not be adverse to the company's interests. If the transaction is an extraordinary transaction, then, in addition to any approval required by the articles of association, it must also be approved by the audit committee and by the board of directors, and, under specified circumstances, by a meeting of the shareholders, as well.

Subject to certain exceptions provided for in the regulations to the Israeli Companies Law, agreements regarding directors' terms of compensation require the approval of the compensation committee, board of directors and the shareholders of the company. In all matters in which a person has a personal interest, including matters of his or her terms of compensation, he or she shall not be permitted to vote on the matter or be present in the meeting in which the matter is considered, however, with respect to an office holder, he/she may be present at the meeting discussions if the chairman determines that the presence of the office holder is necessary in order to present the matter. However, if a majority of the audit committee or of the board of directors has a personal interest in the matter then:

- all of the directors are permitted to vote on the matter and attend the meeting in which the matter is considered; and
  - the matter requires approval of the shareholders at a general meeting.

According to the Israeli Companies Law, the disclosure requirements discussed above also apply to a controlling shareholder of a public company. Such requirements also apply to certain shareholders of a public company who have a personal interest in the adoption of certain proposals with respect to (i) certain private placements that will increase their relative holdings in the company, (ii) certain special tender offers or forced bring along share purchase transactions, (iii) election of external directors, (iv) approval of a compensation policy governing the terms of employment and compensation of office holders, (v) approval of the terms of employment and compensation of the general manager, and (vi) approval of the terms of employment and compensation of office holders of the company when such terms deviate from the compensation policy previously approved by the company's shareholders. If any shareholder casting a vote in connection with such proposals as aforesaid does not notify the company if he, she or it has a personal interest with respect to such proposal, his, her or its vote with respect to the proposal will be disqualified.

The term "controlling shareholder" is defined as a shareholder who has the ability to direct the activities of a company, other than if this power derives solely from the shareholder's position on the board of directors or any other position with the company, and the definition in connection with matters governing: (i) extraordinary transactions with a controlling shareholder or in which a controlling shareholder has a personal interest, (ii) certain private placements in which the controlling shareholder has a personal interest, (iii) certain transactions with a controlling shareholder or relative with respect to services provided to or employment by the company, (iv) the terms of employment and compensation of the general manager, and (v) the terms of employment and compensation of office holders of the company when such terms deviate from the compensation policy previously approved by the company's shareholders, also includes shareholders that hold 25% or more of the voting rights if no other shareholder owns more than 50% of the voting rights in the company (and the holdings of two or more shareholders which each have a personal interest in such transaction will be aggregated for the purposes of determining such threshold).

In general, extraordinary transactions with a controlling shareholder or in which a controlling shareholder has a personal interest, and agreements relating to non-office holder employment and compensation terms of a controlling shareholder (or a relative of such) or to the provision of services to the company by such controlling shareholder (or relative if such), require the approval of the audit committee, the board of directors and the shareholders of the company. Agreements relating to the terms of office and employment of a controlling shareholder (or relative of such) as an office holder in the company require the approval of the compensation committee, the board of directors and the shareholders of the company.

The shareholder approval for such matters requiring shareholder disclosure of a personal interest as noted above, must either include at least one-half of the shares held by non-controlling and disinterested shareholders who actively participate in the voting process (without taking abstaining votes into account), or, alternatively, the total shareholdings of the non-controlling and disinterested shareholders who vote against the transaction must not represent more than two percent of the voting rights in the company. Agreements and extraordinary transactions with a controlling shareholder or in which a controlling shareholder has a personal interest, or agreements relating to any employment terms of a controlling shareholder (or relative if such) or to the provision of services to the company by such controlling shareholder (or relative if such), as aforesaid, with duration exceeding three years, are subject to re-approval once every three years by the audit committee (or compensation committee, as applicable), the board of directors and the shareholders of the company. Extraordinary transactions with a controlling shareholder or in which a controlling shareholder has a personal interest may be approved in advance for a period exceeding three years if the audit committee determines such approval reasonable under the circumstances. In addition, agreements and extraordinary transactions with duration exceeding three years which were approved prior to the recent Sixteenth Amendment to the Companies Law, which was passed by the Israeli legislature, the Knesset, in March 2011 and which came into effect gradually during the year 2011 (the "Sixteenth Amendment") will need to be re-approved by the proper corporate actions at the later of (i) the first general meeting held after May 14, 2011, (ii) November 14, 2011 or (iii) the expiration of three years from the date on which they were originally approved, even though they were properly approved prior to the passing of the Sixteenth Amendment.

The board of directors of a company is obligated to adopt a compensation policy after considering the recommendations of the compensation committee. The final adoption of the compensation committee is subject to the approval of the shareholders of the company. Such shareholder approval is subject to certain special majority requirements, as set forth in Amendment 20, pursuant to which the shareholder majority approval must also either include at least one-half of the shares held by non-controlling and disinterested shareholders who actively participate in the voting process (without taking abstaining votes into account), or, alternatively, the total shareholdings of the non-controlling and disinterested shareholders who voted against the transaction must not represent more than two percent of the voting rights in the company.

Nonetheless, even if the shareholders of the company do not approve the compensation policy, the board of directors of a company may approve the compensation policy, provided that the compensation committee and, thereafter, the board of directors resolved, based on detailed, documented, reasons and after a second review of the compensation policy, that the approval of the compensation policy is for the benefit of the company.

Pursuant to Amendment 20, the terms of office and employment of an office holder in a public company should be in accordance with the company's compensation policy. Nonetheless, provisions were established that allow a company, under special circumstances, to approve terms of office and employment that are not in line with the approved compensation policy. Additionally, Amendment 20 also amended the provisions of the Companies Law which relate to the approval requirements for the compensation and/or terms of office of a specific office holder.

Terms of office and employment of office holders who are neither directors nor the general manager require approval by the (i) compensation committee; and (ii) the board of directors. Approval of terms of office and employment for such office holders which do not comply with the compensation policy may nonetheless be approved subject to two cumulative conditions: (i) the compensation committee and thereafter the board of directors, approved the terms after having taken into account the various policy considerations and mandatory requirements set forth in Amendment 20 with respect to office holder compensation, and (ii) the shareholders of the company approved the terms of office and employment for such office holders by means of the special majority required for approving the compensation policy (as detailed above).

Terms of office and employment of the general manager require approval by the (i) compensation committee; (ii) the board of directors and (iii) the shareholders of the company by means of the special majority required for approving the compensation policy (as detailed above). Approval of terms of office and employment for the general manager which do not comply with the compensation policy may nonetheless be approved subject to two cumulative conditions: (i) the compensation committee and thereafter the board of directors, approved the terms after having taken into account the various policy considerations and mandatory requirements set forth in Amendment 20 with respect to office holder compensation, and (ii) the shareholders of the company approved the terms of office and employment for the general manager which deviate from the compensation policy by means of the special majority required for approving the compensation policy (as detailed above). Notwithstanding the foregoing, a company may be exempted from receiving shareholder approval with respect to the terms of office and employment of a proposed candidate for general manager if such candidate meets certain independence criteria, the terms of office and employment are in line with the compensation policy, and the compensation committee has determined for specified reasons that presenting the matter for shareholder approval would thwart the proposed engagement.

Terms of office and employment of office holders (including the general manager) that are not directors may nonetheless be approved by the company despite shareholder rejection, provided that a company's compensation committee and thereafter the board of directors have determined, based on detailed reasoning, after having re-examined the terms of office and employment, and taken the shareholder rejection into consideration, that the terms of office and employment are beneficial to the company.

Terms of office and employment of directors require approval by the (i) compensation committee; (ii) the board of directors and (iii) the shareholders of the company. Approval of terms of office and employment for directors of a company which do not comply with the compensation policy may nonetheless be approved subject to two cumulative conditions: (i) the compensation committee and thereafter the board of directors, approved the terms after having taken into account the various policy considerations and mandatory requirements set forth in Amendment 20 with respect to office holder compensation, and (ii) the shareholders of the company have approved the terms by means of the special majority required for approving the compensation policy (as detailed above).

Private placements in a public company require approval by a company's board of directors and shareholders in the following cases:

- A private placement that meets all of the following conditions:

- The private placement will increase the relative holdings of a shareholder that holds five percent or more of the company's outstanding share capital, assuming the exercise of all of the securities convertible into shares held by that person, or that will cause any person to become, as a result of the issuance, a holder of more than five percent of the company's outstanding share capital.

- 20 percent or more of the voting rights in the company prior to such issuance are being offered.

- All or part of the consideration for the offering is not cash or registered securities, or the private placement is not being offered at market terms.

- A private placement which results in anyone becoming a controlling shareholder of the public company.

In addition, under the Companies Law, certain transactions or a series of transactions are considered to be one private placement.

Any placement of securities that does not fit the above description may be issued at the discretion of the board of directors.

Under the Israeli Companies Law, a shareholder has a duty to act in good faith towards the company and other shareholders when exercising his or her rights and refrain from abusing his power in the company, including, among other things, voting in the general meeting of shareholders on the following matters:

- any amendment to the articles of association;
- an increase of the company's authorized share capital;
- a merger; or
- approval of interested party acts and transactions that require general meeting approval as provided in sections 255 and 268 to 275 of the Israeli Companies Law.

Furthermore, the Companies Law requires that a shareholder refrain from acting in a discriminatory manner towards other shareholders.

The Companies Law does not describe the substance of the aforementioned duties of shareholders, but provides that laws applicable to a breach of contract, adjusted according to the circumstances shall apply to a breach of such duties. With respect to the obligation to refrain from acting discriminatorily, a shareholder that is discriminated against can petition the court to instruct the company to remove or prevent the discrimination, as well as provide instructions with respect to future actions.

In addition, any controlling shareholder, any shareholder who knows that it possesses power to determine the outcome of a shareholder vote and any shareholder who, pursuant to the provisions of a company's articles of association, has the power to appoint or prevent the appointment of an office holder in the company is under a duty to act with fairness towards the company. The breach of such duty is governed by Israeli contract laws. The Israeli Companies Law does not describe the substance of this duty to act with fairness, but provides that laws applicable to a breach of contract, adjusted according to the circumstances, and taking into account the status within the company of such shareholder, shall apply to a breach of such duty. The Israeli Companies Law requires that specified types of transactions, actions and arrangements be approved as provided for in a company's articles of association and in some circumstances by the audit committee or compensation committee, by the board of directors and by the general meeting of the shareholders.

As stated above, the Israeli legislature, the Knesset, approved the Sixteenth Amendment to the Israeli Companies Law which came into effect during 2011, and Amendment 20 which came into effect at the end of 2012. The main purpose of the Sixteenth Amendment is to revise and enhance existing provisions governing corporate governance practices of Israeli companies, and the changes in the Sixteenth Amendment are incorporated into the above discussions of the Company. The main purpose of Amendment 20 is to regulate executive pay in Israeli publicly traded companies and to revise and enhance existing provisions governing approval of executive compensation. Additional changes to the Companies Law pursuant to these recently passed amendments include:

- **Code of Corporate Governance.** Under the Sixteenth Amendment, a code of recommended corporate governance practices has been attached as an annex to the Companies Law. In the explanatory notes to the legislation, the Knesset noted that an "adopt or disclose non-adoption" regulation would be issued by the Israeli Securities Authority with respect to such code. As of the date of this Annual Report, the Israeli Securities Authority has issued reporting instructions with respect to this code which are applicable only to publicly traded companies whose securities are traded solely on the Tel Aviv Stock Exchange and which report solely to the Israeli Securities Authority.
- **Fines.** The Israeli Securities Authority shall be authorized to impose fines on any person or company performing a violation, in connection with a publicly traded company which reports to the Israeli Securities Authority, and specifically designated as a violation under the Sixteenth Amendment.

Although we expect to be in compliance with the Companies Law, there is no assurance that we will not be required to adjust our current corporate governance practices, as discussed in this annual report, pursuant to the provisions of the Companies Law, and recently passed amendments to the Companies Law.

#### The Israeli Securities Law- 1968 and the Securities Law Amendment

On February 27, 2011, an amendment to the Israeli Securities Law- 1968 (the "Israeli Securities Law") came into effect (the "Securities Law Amendment"), which applies to Israeli public companies, including companies the securities of which are also listed on NASDAQ Global Market. The main purpose of the Securities Law Amendment is creating an administrative enforcement procedure to be used by the Israeli Securities Authority ("ISA") to enhance the efficacy of enforcement in the securities market in Israel. The new administrative enforcement procedure may be applied to any company or person (including director, officer or shareholder of a company) performing any of the actions specifically designated as breaches of law under the Securities Law Amendment.

Furthermore, the Securities Law Amendment requires that the chief executive officer of a company supervise and take all reasonable measures to prevent the company or any of its employees from breaching the Israeli Securities Law.

Under the Securities Law Amendment, a company cannot obtain insurance against or indemnify a third party (including its officers and/or employees) for any administrative procedure and/or monetary fine (other than for certain legal expenses and payments of damages to an injured party). The Securities Law Amendment permits insurance and/or indemnification for expenses related to an administrative procedure, such as reasonable legal fees, provided that it is permitted under the company's articles of association. In January 2012 each of our Audit Committee and Board of Directors approved a new form of Indemnification Agreement with our directors and officers serving in such positions from time to time so as to reflect this amendment, subject to approval of our shareholders to the relevant changes required to our Articles of Association. Our shareholders approved these amendments to the Articles of Association and a revised form of Indemnification Agreement for directors serving in such capacity from time to time, at the Annual General Meeting of the Shareholders held on April 11, 2012.

We continue to examine the implications of the Securities Law Amendment and to review all of our internal policies and procedures in order to ensure compliance with all the securities laws to which we are subject; however, its effect and consequences, as well as our scope of exposure, are yet to be entirely determined in practice. There is no assurance that we will not be required to take certain actions in order to enhance our compliance with the provisions of the Securities Law Amendment, such as adopting and implementing an internal enforcement plan as well as additional internal policies and procedures in order to reduce our exposure to potential breaches of the Israeli Securities Law.



## NASDAQ Listing Rules and Home Country Practices

In accordance with Israeli law and practice and subject to the exemption set forth in NASDAQ Listing Rule 5615(a)(3), we follow the provisions of the Israeli Companies Law – 1999, with respect to the following requirements:

- **Distribution of annual and quarterly reports to shareholders** – Under Israeli law we are not required to distribute annual and quarterly reports directly to shareholders and the generally accepted business practice in Israel is not to distribute such reports to shareholders. We do however make our audited financial statements available to our shareholders prior to our annual general meeting and furnish our quarterly and annual financial results with the Securities and Exchange Commission on Form 6-K.
- **Independence, Nomination and Compensation of Directors** – A majority of our board of directors is not comprised of independent directors as defined in NASDAQ Listing Rule 5605(a)(2). Our board of directors contains two external directors in accordance with the provisions contained in Sections 239-249 of the Israeli Companies Law – 1999. Israeli law does not require, nor do our external directors conduct, regularly scheduled meetings at which only they are present. In addition, with the exception of our external directors, our directors are elected for terms of one year or until the following annual meeting, by a general meeting of our shareholders. The nominations for director which are presented to our shareholders are generally made by our directors. One or more shareholders of a company holding at least one percent of the voting power of the company may nominate a currently serving external director for an additional three year term. Israeli law does not require the adoption of and our board has not adopted a formal written charter or board resolution addressing the nomination process and related matters. Compensation of our directors and other officers is determined in accordance with Israeli law.
- **Audit Committee**– Our audit committee does not meet with all the requirements of NASDAQ Listing Rule 5605. We are of the opinion that the members of our audit committee comply with the requirements of NASDAQ Listing Rule 5605(c)(3) and Rule 10A-3(b) of the general rules and regulations promulgated under the Securities Act of 1933 and all requirements under Israeli law. Our audit committee has not adopted a formal written audit committee charter specifying the items enumerated in NASDAQ Listing Rule 5605(c)(1).
- **Quorum** – Under Israeli law a company is entitled to determine in its articles of association the number of shareholders and percentage of holdings required for a quorum at a shareholders meeting. Our Articles of Association provide that a quorum of two or more shareholders, present in person or by proxy, holding shares conferring in the aggregate more than thirty three and a third (33 1/3 %) percent of the voting power of the Company is required for commencement of business at a general meeting.

- Approval of Related Party Transactions – All related party transactions are approved in accordance with the requirements and procedures for approval of interested party acts and transactions, set forth in sections 268 to 275 of the Israeli Companies Law-1999.
- Shareholder Approval – We seek shareholder approval for all corporate action requiring such approval, in accordance with the requirements of the Israeli Companies Law – 1999.

C. Material Contracts

All of our contracts over the past two years have been entered into in the ordinary course of business, except for our real property leases. Information regarding our real property leases is provided in “Item 4. Information on the Company – Property, Plant and Equipment” and "Item 19. Exhibits".

D. Exchange Controls

Under current Israeli regulations, any dividends or other distributions paid in respect of our ordinary shares purchased by nonresidents of Israel with certain non-Israeli currencies (including dollars) and any amounts payable upon the dissolution, liquidation or winding up of our affairs, as well as the proceeds of any sale in Israel of our securities to an Israeli resident, will be freely repatriable in such non-Israeli currencies at the rate of exchange prevailing at the time of conversion pursuant to the general permit issued under the Israeli Currency Law, 1978, provided that Israeli income tax has been paid on (or withheld from) such payments. Because exchange rates between the NIS and the U.S. dollar fluctuate continuously, U.S. shareholders will be subject to any such currency fluctuation during the period from when such dividend is declared through the date payment is made in U.S. dollars.

Investments outside Israel by the Company no longer require specific approval from the Controller of Foreign Currency at the Bank of Israel.

E. Taxation

The following is a summary of some of the current tax law applicable to companies in Israel, with special reference to its effect on us. The following also contains a discussion of specified Israeli tax consequences to our shareholders and government programs from which we benefit. To the extent that the discussion is based on tax legislation (including the legislation passed as part of the recent tax reform in Israel) that has not been subject to judicial or administrative interpretation, there can be no assurance that the views expressed in the discussion will 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 is not exhaustive of all possible tax considerations.

Holders of our ordinary shares should consult their own tax advisors as to the United States, Israeli or other tax consequences of the purchase, ownership and disposition of our ordinary shares, or receipt of any dividend distributions made to our shareholders, including, in particular, the effect of any foreign, state or local taxes, and of any taxes withheld at source by the Company.

#### General Corporate Tax

Israeli companies are subject to corporate tax at the rate of 25%. However, the effective tax rate payable by a company which derives income from a Benefited Enterprise (as further discussed below) may be considerably less.

#### Law for the Encouragement of Capital Investments, 1959

Certain of our facilities have been granted "Benefited Enterprise" status under the Law for the Encouragement of Capital Investments, 1959, as amended (the "Investment Law"). The Investment Law provides that a capital investment in eligible facilities may, upon application to the Israel Investment Center of the Ministry of Industry and Trade of the State of Israel (referred to as the Investment Center), be designated as a Benefited Enterprise. Each certificate of approval for a Benefited Enterprise relates to a specific investment program delineated both by its financial scope, including its capital sources and its physical characteristics, for example, the equipment to be purchased and utilized pursuant to the program. The tax benefits derived from any such certificate of approval relate only to taxable income attributable to the specific Benefited Enterprise.

An amendment to the Investment Law which came into effect as of April 1, 2005 (the "First Amendment") has significantly changed the provisions of the Investment Law. The First Amendment determined criteria for the approval of a facility as a Benefited Enterprise, such as provisions generally requiring that at least 25% of the income of a Benefited Enterprise will be derived from exports. Additionally, as explained below, the First Amendment sets forth major changes in the manner in which tax benefits were awarded under the Investment Law whereby companies were no longer require Investment Center approval (and Benefited Enterprise status) 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 Investment Law as in effect on the date of such approval. Therefore the tax benefits granted to our Benefited Enterprises under the Investment Law will generally not be subject to the provisions of the First Amendment. Many of the requirements under the Investment Law following the First Amendment were amended again in a second amendment to the Investment Law (the "Second Amendment"), as will be described below.

### Tax Benefits Prior to the First Amendment

In general, taxable income of a company derived from a Benefited Enterprise was subject to tax exemption and/or reduced corporate tax (this will also apply to Benefited Enterprises approved after the First Amendment, as explained below). The reduced corporate tax rate applies for a period of time termed the “benefit period”. The benefit period was a period of seven years commencing with the year in which the Benefited Enterprise first generates taxable income. In any event, the benefit period was limited to 12 years from the commencement of production or operation, or 14 years from the year in which the approval was received, whichever is earlier. Under certain circumstances (as further detailed below), the benefit period may have been extended to a maximum of ten years from the commencement of the benefit period. In the event that a company was operating under more than one approval or that only part of its capital investments were approved (a “Mixed Enterprise”), its effective corporate tax rate was the result of a weighted combination of the various applicable rates.

Prior to the First Amendment, a company owning a Benefited Enterprise approved after April 1, 1986 (or prior thereto provided no government grants or loans had previously been granted regarding such enterprise) was entitled to elect (as we have) to forego certain Government grants extended to Benefited Enterprises in return for an “alternative route” of tax benefits (the “Alternative Route”). Under the Alternative Route, a company’s undistributed income derived from a Benefited Enterprise was exempt from corporate tax for a period of between two and ten years from the first year of taxable income, depending on the geographic location of the Benefited Enterprise within Israel, and such company was eligible for the reduced tax rates under the Investment Law for the remainder of the benefit period as mentioned above.

Our production facilities have been granted “Benefited Enterprise” status under the Alternative Route according to the Investment Law. The initial Benefited Enterprise status was granted in 1988 (“Initial Benefited Enterprise”). An extension program was granted Benefited Enterprise status in 1995 (the “Extended Benefited Enterprise”). Income derived from our Benefited Enterprises is tax exempt during six years of the seven year tax benefit period and is subject to a reduced tax rate of 25% in the seventh year. The seven year period of benefits commences in the year the Benefited Enterprise first earns taxable income but is limited to twelve years from commencement of production or fourteen years from date of approval, whichever is earlier. The period of tax benefits, relating to our Initial Benefited Enterprise, commenced in 1991 and expired in 1997. The period of tax benefits relating to our Extended Benefited Enterprise commenced in 1997 and expired in 2006, as explained below.

In June 1995, we reached an agreement with the tax authorities regarding our entitlement to benefits under the Investment Law. The agreement, effective from tax year 1994 and thereafter, relates to the method of determination of taxable income from our research and development activities. Pursuant to the agreement, for the purpose of determining our tax liability, our income will be allocated to our manufacturing plant and to our research and development center, according to a formula based on the net costs plus royalties of the research and development center and our profitability. Income allocated to the expansion of the manufacturing plant will benefit from a ten-year tax exemption, while income allocated to the research and development center will benefit from a two-year exemption, and for a five-year period immediately following will be taxed at a 25% rate.

Our income to be attributed to our Extended Benefited Enterprise in any year will be computed as a ratio of the increase in our sales turnover, if any, in that year to our turnover in the year before the Extended Benefited Enterprise commenced its tax benefits entitlement. The tax authorities have reserved their right to reconsider our claim to such tax benefits in future years.

The entitlement to the above benefits is conditional upon our fulfillment of the conditions stipulated by the law, regulations published thereunder and the instruments of approval for the specific investments in the Benefited Enterprise. In the event of failure to comply with these conditions, the benefits may be canceled and we may be required to refund the amount of the benefits, in whole or in part, with the addition of linkage differences, interest and penalties. Should we derive income from sources other than the Benefited Enterprise during the relevant periods of benefits, such income will be taxable at regular corporate tax rates stated above.

A company that elected the Alternative Route prior to the First Amendment and that subsequently paid a dividend out of tax exempted income derived from the Benefited Enterprise(s) will be subject to Company Tax in the year the dividend is distributed in respect of the amount distributed (including the corporate tax thereon), at the rate that would have been applicable had the company not elected the Alternative Route (25%). In addition, the dividend recipient is taxed at the rate applicable to dividends from Benefited Enterprises (15%), if the dividend is distributed during the tax exemption period or within a specified period thereafter (in the event, however, that the company qualified as a Foreign Investors' Company, there was no such time limitation).

Subject to certain provisions concerning income subject to the Alternative Route, all dividends are considered to be attributable to the entire enterprise and the effective tax rate is the result of a weighted combination of the various applicable tax rates. Under the Investment Law, a company that has elected the alternative package of benefits was not required to distribute exempt retained profits, and may generally decide from which year's profits to declare dividends.

The Investment Law also provided that a Benefited Enterprise was entitled to accelerated depreciation on its property and equipment that were included in an approved investment program. We have not utilized this benefit.

Grants and certain other incentives received by a company in accordance with the Investment Law remained subject to final ratification by the Israel Investment Center and final determination by the Israel Tax Authority. Such ratification and determination were conditional upon fulfillment of all of the terms of the approved program.

### Tax Benefits under the First Amendment

As a result of the First Amendment, a company was no longer required to acquire Benefited Enterprise status in order to receive the tax benefits previously available under the Alternative Route and therefore such companies did not need to apply to the Investment Center for this purpose. However, the Investment Center continued granting Benefited Enterprise status to companies seeking Governmental grants. A company could have claimed the tax benefits offered by the Investment Law directly in its tax returns, provided that its facilities meet the criteria for tax benefits set forth in the First Amendment (a “Benefited Enterprise”). Companies were also entitled to approach the Israeli Tax Authority for a pre-ruling regarding their eligibility for benefits under the First Amendment. The First Amendment included provisions intended to ensure that a company will not enjoy both government grants and tax benefits for the same investment program.

Tax benefits were available under the First Amendment to production facilities and other eligible facilities, which were generally required to derive more than 25% of their business income from exports. In order to receive the tax benefits, the First Amendment stated that the company must make an investment in the Benefited Enterprise exceeding a minimum amount specified in the Investment Law. Such investment could have been made over a period of no more than three years, such period concluding at the end of the year in which the company requested to have the tax benefits apply to its Benefited Enterprise (the “Year of Election”). Where the company requested to have the tax benefits apply to an expansion of existing facilities, only the expansion was considered a Benefited Enterprise and the company’s effective tax rate was the result of a weighted combination of the applicable rates. In the case of an expansion of existing facilities, the minimum investment required in order to qualify as a Benefited Enterprise was determined as a certain percentage of the company’s production assets before the expansion and in any case was not less than NIS 360,000.

The tax benefits which were available under the First Amendment to qualifying income of a Benefited Enterprise were determined by the geographic location of the Benefited Enterprise in Israel. The Investment Law divides the country into three zones – A, B and C, so that a Benefited Enterprise operating in Zone A (which generally includes areas remote from the center of Israel) received the greatest benefits and Benefited Enterprises in Zone C received the least benefits.

The First Amendment provided that a company producing income from a Benefited Enterprise in Zone A could have elected either that (i) the undistributed income derived from the Benefited Enterprise will be fully tax exempt for the entire benefit period described below (“tax exemption”), in which case the ordinary provisions described below concerning the taxation of the company and shareholder for distribution of dividends will apply; or (ii) that the income from its Benefited Enterprise will be subject to corporate tax at a rate of 11.5%, in which case dividends paid out of such income to a foreign resident will be taxed at a rate of 4% and to an Israeli resident will be taxed at a rate of 15%, and the company will not be subject to additional tax upon dividend distribution. Further benefits were available in the event of certain large investments by multinational companies. Benefited Enterprises located in Zones B and C was exempt from tax for six and two years, respectively, and subject to tax at a rate of 10%-25% for the remainder of the benefit period, depending on the extent of foreign investment in the Company, as described above.

Dividends paid out of income derived by a Benefited Enterprise, or out of dividends received from a company whose income was derived from a Benefited Enterprise, were generally subject to withholding tax at the rate of 15% or less under certain anti double-taxation treaties, such tax being deductible at source. The reduced withholding tax rate of 15% was limited to dividends and distributions out of income derived during the benefit period and actually paid at any time up to 12 years thereafter. A company qualified for tax benefits under the First Amendment which paid a dividend out of income derived by its Benefited Enterprise during the tax exemption period will be subject to corporate tax in respect of the gross amount of the dividend. The rate of the tax was the rate which would have been applicable had the company not been tax exempt. Such tax rate was lower in the case of a qualified "Foreign Investors' Company".

The period for which tax benefits were available under the First Amendment was also determined by the geographical location of the Benefited Enterprise in Israel. The benefit period for Benefited Enterprises in Zone A ended on the earlier of (i) a period of ten years from the tax year in which the company first derived taxable income from the Benefited Enterprise (the "Commencement Year"); or (ii) twelve years (or in certain cases fourteen years) from the first day of the Year of Election. The benefit period for Benefited Enterprises in Zones B and C was extended until the earlier of (i) seven years from the Commencement Year or (ii) 12 years from the first day of the Year of Election. This period could have been extended for Benefited Enterprises owned by a "Foreign Investors' Company" during all or part of the benefit period.

Additionally, the First Amendment sets forth a minimal amount of foreign investment required for a company to be regarded a Foreign Investors' Company.

We have selected the 2004 tax year, the 2006 tax year, the 2009 tax year and the 2012 tax year to be our Year of Election, from which the period of benefits under the Investment Law commenced.

There can be no assurance that we will attain approval for additional tax benefits under the Amendment, or receive approval for Benefited Enterprises in the future.

#### The Second Amendment to the Investment Law

The Israeli legislature, the Knesset, approved significant changes to the Investment Law, which revamped the tax incentive regime in Israel and which became effective as of January 1, 2011. The main changes enacted under the Second Amendment are, inter alia, as follows:

- Replacement of all future tax incentives under the existing law as amended by the First Amendment; as a result, commencing 2011, industrial companies that meet the conditions set out by the Second Amendment will no longer be entitled to the existing tax incentives provided under the First Amendment, such as the exemption from tax on undistributed profits and a reduced tax rate thereafter, but rather to the tax incentives under the Second Amendment.

- Under the transition provisions, any tax benefits obtained prior to 2011 shall continue to apply until expired, unless the company elects to apply the provisions of the Second Amendment to its income.
- Industrial companies meeting the criteria set out by the Investment Law will be eligible for flat tax rates of 10% or 15% for the years 2011 through 2012, 7% or 12.5% for years 2013 through 2014 and 6% or 12% for years 2015 onwards, with the actual tax rates determined by the location of the enterprise. Under the Second Amendment, the tax incentives offered by the Investment Law are no longer dependant neither on minimum qualified investments nor on foreign ownership.
- Companies will be able to enjoy both government grants and tax benefits concurrently. Governmental grants will not necessarily be dependent on the extent of enterprise's investment in assets and/or equipment. Commencing 2011, the approval of "Preferred Enterprise" status by either the Israeli Tax Authorities or the Investment Center will be accepted by the other. Therefore a Preferred Enterprise will be eligible to receive both tax incentives and government grants, under certain conditions.

Chapter B1 of the Investment Law determines that the "Preferred Income" of a "Preferred Enterprise" will be subject to corporate income tax rate of 10% if located in a preferred zone or 15% if not located in a preferred zone in years 2011-2012. The said corporate tax rate will be decreased to 7% (preferred zone) or 12.5% (not preferred zone), for years 2013-2014 and 6% (preferred zone) or 12% (not preferred zone) from 2015 and onwards.

"Preferred Income" is defined as income from the sale of products of the Preferred Enterprise (including components that were produced by other enterprises); income from the sale of semiconductors by other non related enterprises which use the Preferred Enterprise's self-developed know-how; income for providing a right to use the Preferred Enterprise's know-how or software; royalties from the use of the know-how or software which was confirmed by the Head of The Investment Center to be related to the production activity of the Preferred Enterprise and services with respect to the aforementioned sales. In addition, the definition of "Preferred Income" also includes income from the provision of industrial R&D services to foreign residents to the extent that the services were approved by the Head of Research for the Industrial Development and Administration.

A "Preferred Enterprise" is defined as an Industrial Enterprise (including, inter alia, an enterprise which develops software, an enterprise which provides approved R&D services to foreign residents and an enterprise which the Chief Scientist confirmed is carrying out R&D in the field of alternative energy), which generally more than 25% of its business income is from export. As mentioned above, the new tax incentives no longer depend on minimum qualified investments nor on foreign ownership.



Chapter B2 of the Investment Law determines the conditions and limitations applying to the tax benefits offered to a "Special Preferred Enterprise". Chapter B2 determines that a "Special Preferred Enterprise" will be able to enjoy corporate income tax rate in a rate of 5% if located in a preferred zone and 8% if not located in a preferred zone.

A "Special Preferred Enterprise" is defined following the Second Amendment as a Preferred Enterprise which meets one of the following conditions: (a) its Preferred Income is equal to or exceeds NIS 1.5 billion; (b) the total income of the company which owns the Preferred Enterprise or which operates in the same field of the Preferred Enterprise and which consolidates in its financial reports the company that owns the Preferred Enterprise equals or exceeds NIS 20 billion; and (c) its business plan was approved by the authorities as significantly benefitting the Israeli economy, either by an investment of at least NIS 400 - 800 million in assets; 100 - 150 million NIS in R&D or the employment of at least 250 to 500 new employees, for preferred zones and regular zones, respectively.

Dividends paid out of income attributed to a Preferred Enterprise are generally subject to withholding tax at source at a rate of 15% or such lower rate as may be provided in an applicable tax treaty, subject to the submission and approval of a request submitted on behalf of the recipient of such dividends to the Israel Tax Authority. However, if such dividends are paid to an Israeli company no tax will be withheld. Such an exemption may apply under the transition rules also to dividends distributed to an Israeli company by an Israeli company which owns a Benefited Enterprise or a Benefited Enterprise and which elected to convert to the new law until June 30, 2015 (in respect to their existing programs).

The Company is currently examining the implications of the Second Amendment to the Investment Law. As the date of filing this Annual Report the Second Amendment is not relevant to us. Furthermore, there can be no assurance that we will comply with the conditions of the Investment Law in the future or that we will be entitled to any additional benefits under the amended Investment Law under the First Amendment and/or the Second Amendment and whether the influence of the expected changes will be beneficial to the Company or not.

#### Possible low tax rates on Captive Profits

Notwithstanding the aforesaid, the Company may be eligible for a lower corporate tax rates according to Amendment No. 69 of the Investment Law ("Captive Profits Amendment"). Temporary incentives are granted according to the Captive Profits Amendment to companies that elect until November 11, 2013 to distribute dividends accumulated before December 31, 2011 ("Accrued Income") out of profits that were exempt from corporation tax according to the Investment Law. Such a company can be entitled to pay a lower corporation tax rate instead of full tax rate (25%) imposed on distributed profits ("Special Tax Rate"). The Special Tax Rate is determined according to a formula which takes into consideration the amount of distributed income out of the Accrued Income and subject to the conditions set forth in the Investments Law. Hence, the special tax rate can vary between 6% and 17.5%.

#### Law for the Encouragement of Industrial Research and Development, 1984

Under the Law for the Encouragement of Industrial Research and Development (the “Research Law”), research and development programs approved by the Research Committee (the “Research Committee”) of the Office of the Chief Scientist (“OCS”) are eligible for grants or loans if they meet certain criteria, in return for the payment of royalties from the sale of the product developed in accordance with the program and subject to other restrictions. Once a project is approved, the OCS will award grants of up to 50% of the project’s expenditures in return for royalties, usually at the rate of 3% to 6% of sales of products developed with such grants. For projects approved after January 1, 1999, the amount of royalties payable is up to a dollar-linked amount equal to 100% of such grants plus interest at LIBOR. There is no further liability for payment.

The terms of these grants prohibit the manufacture outside of Israel of the product developed in accordance with the program without the prior consent of the Research Committee of the OCS. Such approval, if granted, is generally subject to an increase in the total amount to be repaid to the OCS to between 120% and 300% of the amount granted, depending on the extent of the manufacturing to be conducted outside of Israel.

The Research Law also provides that know-how from the research and development, which is used to produce the product, may not be transferred to Israeli third parties without the approval of the Research Committee. Until 2005, the Research Law stated that such know-how may not be transferred to non-Israeli third parties at all. An amendment to the Research Law has set forth certain exceptions to this rule; however, the practical implications of such exceptions are quite limited. The Research Law has stressed, that it is not just transfer of know-how that is prohibited, but also transfer of any rights in such know-how. Such restriction does not apply to exports from Israel of final products developed with such technologies. Approval of the transfer may be granted only if the transferee undertakes to abide by all of the provisions of the Research Law and regulations promulgated thereunder, including the restrictions on the transfer of know-how and the obligation to pay royalties. There can be no assurance that such consent, if requested, will be granted or, if granted, that such consent will be on reasonable commercial terms.

#### Tax Benefits for Research and Development

Israeli tax law allows, under certain conditions, a tax deduction in the year incurred for expenditures (including capital expenditures) in scientific research and development projects, if the expenditures are approved by the relevant Israeli Government Ministry (determined by the field of research) and the research and development is for the promotion of the enterprise and is carried out by or on behalf of the company seeking such deduction. Such expenditures not so approved are required to be deducted over a three-year period. Though we received such approvals for the years 2006, 2007 and 2008 and could deduct the expenditures in the year the expenditures were incurred, we chose to deduct the expenditures over a three-year period. We also received such approvals for the years 2009, 2010 and 2011 and deducted such expenditures in the year the expenditures were incurred.

#### Law for the Encouragement of Industry (Taxes), 1969

Under the Law for the Encouragement of Industry (Taxes), 1969 (the “Industry Encouragement Law”), Industrial Companies (as defined below) are entitled to the following tax benefits:

- (a) Amortization of purchases of know-how and patents over eight years for tax purposes.
- (b) Amortization of expenses incurred in connection with certain public securities issuances over a three-year period.
- (c) Accelerated depreciation rates on equipment and buildings.

Eligibility for benefits under the Industry Encouragement Law is not subject to receipt of prior approval from any governmental authority. Under the Industry Encouragement Law, an “Industrial Company” is defined as a company resident in Israel, at least 90% of the income of which, in any tax year, determined in Israeli currency, exclusive of income from government loans, capital gains, dividends, interest and linkage differences, is derived from an “Industrial Enterprise” owned by it. An “Industrial Enterprise” is defined as an enterprise whose major activity in a given tax year is industrial production activity.

We believe that we currently qualify as an Industrial Company within the definition of the Industry Encouragement Law. No assurance can be given that we will continue to qualify as an Industrial Company or that the benefits described above will be available in the future.

#### Calculation of Results for Tax Purposes

The Israeli Income Tax Regulations (Rules for Maintaining Accounting Records of Foreign Investors’ Companies and Certain Partnerships and Determining Their Taxable Income) - 1986 provide that as a Foreign Investors’ Company (as defined in the Investment Law described above) is eligible to calculate its taxable income in accordance with these regulations, and therefore, if we elect to follow such regulations, our taxable income or loss is to be calculated in dollars. We have elected to apply these regulations and accordingly our taxable income or loss is calculated in dollars in the manner set forth in such regulations.

#### Capital Gains Tax on Sales of Our Ordinary Shares

Until the end of the year 2002 and provided we maintained our status as an industrial corporation, capital gains from the sale of our securities were generally exempt from Israeli Capital Gains Tax. This exemption did not apply to a shareholder whose taxable income is determined pursuant to the Israeli Income Tax Law (Inflationary Adjustments) 1985, or to a person whose gains from selling or otherwise disposing of our securities were deemed to be business income.

On January 1, 2003 an amendment to the Israeli tax regime became effective. This was followed by new amendments made to the Israeli Income Tax Ordinance which were enacted in 2011 which have an effect for income derived as of 2012.

An individual is subject to a 25% tax rate on real capital gains derived from the sale of shares, as long as the individual is not a "substantial shareholder" (generally a shareholder with 10% or more of the right to profits, right to nominate a director and voting rights) in the company issuing the shares.

A substantial shareholder will be subject to tax at a rate of 30% in respect of real capital gains derived from the sale of shares issued by a company in which he or she is a substantial shareholder. The determination of whether the individual is a substantial shareholder will be made on the date on which the securities are sold. In addition, the individual will be deemed to be a substantial shareholder if at any time during the 12 months preceding the date of sale, he or she was a substantial shareholder.

Non-Israeli residents are exempt from Israeli capital gains tax on any gains derived from the sale of shares in an Israeli corporation publicly traded on TASE and/or on a foreign stock exchange, provided among others, that such gains do not derive from a permanent establishment of such shareholders in Israel and that such shareholders did not acquire their shares prior to the issuer's initial public offering. However, non-Israeli corporations will not be entitled to such exemption if an Israeli resident has a controlling interest of 25% or more in such non-Israeli corporation, or is the beneficiary of, or is entitled to, 25% or more of the revenues or profits of such non-Israeli corporation, whether directly or indirectly.

In some instances where our shareholders may be liable for Israeli tax on the sale of their ordinary shares, the payment of the consideration may be subject to the withholding of Israeli tax at the source.

#### Taxation of Dividends

Non-residents of Israel are subject to income tax on income accrued or derived from sources in Israel. These sources of income include, among others, passive income such as dividends, royalties and interest, as well as non-passive income from services rendered in Israel. On distributions of dividends (other than bonus shares or stock dividends) to Israeli individuals and foreign resident individuals and corporations we would be required to withhold income tax at the rate of 25-30%. If the income out of which the dividend is being paid is attributable to an Benefited Enterprise or Preferred Enterprise under the Investment Law, the rate is generally 15%; provided that, if the dividend is attributable partly to income derived from a Benefited Enterprise, and partly to other sources of income, the withholding rate will be a blended rate reflecting the relative portions of the two types of income. A different tax rate may be provided for in a treaty between Israel and the shareholder's country of residence. Under the U.S.-Israel tax treaty, if the income out of which the dividend is being paid is not attributable to a Benefited Enterprise, then we are required to withhold income tax at a rate of 12.5% with respect to shareholders that are U.S. corporations and held at least 10% of our voting power in the 12 month period preceding the distribution of such dividends.

The withheld tax is the final tax in Israel on dividends paid to non-residents who do not conduct business in Israel. A non-Israeli resident who has interest or dividend income derived from or accrued in Israel, from which tax was withheld at source, is generally exempt from the duty to file tax returns in Israel in respect of such income, provided that such income was not derived from a business conducted in Israel by the taxpayer.

Residents of the United States will generally have taxes in Israel withheld at source.

#### Passive Foreign Investment Company Status under U.S. Federal Income Tax Law

In general, a non-U.S. corporation will be classified for U.S. tax purposes as a passive foreign investment company (hereafter also referred to as a “PFIC”) in any taxable year in which either (i) 75% or more of its gross income (including the pro-rata gross income of any company (U.S. or foreign) in which it is considered to own 25% or more of the ordinary shares by value) for the taxable year is passive income, or (ii) at least 50% of the average value of all of its gross assets (including the pro-rata fair market value of the assets of any company in which it is considered to own 25% or more of the ordinary shares by value) during the taxable year, calculated quarterly by value, produce, or are held for the production of, passive income. Passive income for these purposes includes items such as dividends, interest, royalties, rents and gains from commodities and securities transactions.

If we are classified as a passive foreign investment company, highly complex rules will apply to our U.S. shareholders. Accordingly, U.S. shareholders are urged to consult their tax advisors regarding the application of such rules.

If a corporation is a passive foreign investment company, a U.S. shareholder will be subject to one of three alternative taxing regimes:

The simplest is the “QEF” regime. If the shareholder elects to treat the PFIC as a “qualified electing fund” (“QEF”), then each year the shareholder includes in its gross income a proportionate share of the PFIC’s ordinary income and net capital gain. We do not currently intend to prepare or provide the information that would enable you to make a Qualified Election Fund election. A second regime may be elected if the PFIC stock is “marketable.” The U.S. shareholder may elect to “mark the stock to market” each year. At the end of each taxable year, the shareholder recognizes gain equal to the excess of the fair market value of the PFIC stock over the shareholder’s tax basis in the stock. (Losses may also be recognized to the extent of previously recognized gains.)

A U.S. shareholder making neither of these elections is subject to the “excess distribution” regime. The tax is triggered when the shareholder receives an “excess distribution” from the PFIC. An excess distribution is either (1) a distribution with respect to stock that is greater than 125% of the average of such distributions over the preceding three years, or (2) 100% of the gain from the disposition of shares in the PFIC.

An excess distribution is subject to special tax rules. In most cases, only a portion of it is included in the gross income of the U.S. shareholder and taxed at normal rates. The remainder is never so included, but is used as the basis for calculating a “deferred tax amount”, which is simply added to the shareholder’s tax liability.

The deferred tax amount is computed as follows. The excess distribution is first ratably allocated, share by share, to each day of the shareholder’s holding period. Portions allocated to the current year, and to any pre-PFIC years (that is, years before 1987, when there were no PFICs, or years before the first year in which the company was a PFIC with respect to that shareholder), are included in ordinary income for the current year. Portions allocated to prior PFIC years are hypothetically taxed at the highest marginal rate in effect for those years (without regard to the shareholder’s actual rate or to any deductions or credits for those years). To this hypothetical tax is added the interest that the shareholder would have paid if it were simply paying that tax late for that year. The sum of the tax and the interest charge is the deferred tax amount, which cannot be offset or otherwise affected by current net operating losses or other deductions.

A U.S. person who inherits shares in a foreign corporation that was a PFIC in the hands of the decedent (who did not make either of the elections described above), is denied the otherwise available step-up in the tax basis of such shares to fair market value at the date of death. The U.S. person steps into the shoes of the decedent and will be subject to the rules described above.

Although a determination as to a corporation’s PFIC status is made annually, an initial determination that a corporation is a PFIC for any taxable year generally will cause the above-described consequences to apply for all future years as to U.S. shareholders who held shares in the corporation at any time during the PFIC taxable year and who made neither a valid QEF election with respect to such shares nor a valid election to mark such shares to market. This will be true even if the corporation loses its PFIC status in later years. However, with respect to a PFIC that does not make any distributions or deemed distributions, the above tax treatment would apply only to gains realized on the disposition of such shares by a U.S. shareholder.

If we are classified as a PFIC, complicated rules will apply to our U.S. shareholders. Our status in future years will depend on our assets and activities in those years, although shareholders will be treated as continuing to own an interest in a passive foreign investment company if we are a passive foreign investment company in any year in which a shareholder owns our shares, unless certain elections are made.

This discussion does not address all aspects of U.S. federal income taxation that may be relevant to a U.S. shareholder in light of his or her particular circumstances or to a U.S. shareholder subject to special treatment under U.S. federal income tax law. We do not currently intend to prepare or provide the information that would enable you to make a Qualified Election Fund election. U.S. shareholders are urged to consult their tax advisors about the U.S. federal income taxation rules to which they will be subject, as well as the PFIC rules, including the advisability, procedure and timing of making a mark-to-market election, in connection with their holding of our shares, including warrants or rights to acquire our shares.

#### Tax Assessment

The Company and its subsidiary file income tax returns in Israel and in the US. The Israeli tax returns of the Company are open to examination by the Israeli tax authorities for the tax years beginning in 2009. The Federal tax returns of the US subsidiary are open to examination by the Federal tax authorities for tax years beginning in 2009, and the New Jersey State tax returns of the US subsidiary are open to examination by the New Jersey state tax authorities for the tax years beginning in 2008. The California State tax returns of the US subsidiary are open to examination by the California state tax authorities for tax years beginning in 2011.

#### F. Dividends and Paying Agents

Not applicable

#### G. Statement by experts

Not applicable

#### H. Documents on Display

We are required to file reports and other information with the Securities and Exchange Commission (the "SEC") under the Securities Exchange Act of 1934 (the "Exchange Act") and the regulations thereunder applicable to foreign private issuers. Although as a foreign private issuer we are not required to file periodic information as frequently or as promptly as United States companies, we generally do publicly announce our quarterly and year-end results promptly and file periodic information with the SEC under cover of Form 6-K. We are also exempt from the rules under the Exchange Act prescribing the furnishing and content of proxy statements and our officers, directors and principal shareholders are exempt from the reporting and other provisions in Section 16 of the Exchange Act.

You may review a copy of our filings with the SEC, including any exhibits and schedules, at the SEC's public reference room at 100 F Street N.E., Washington, D.C. 20549. You may call the SEC at 1-800-SEC-0330 for further information on the public reference room. As a foreign private issuer, all documents which were filed after November 4, 2002 on the SEC's EDGAR system will be available for retrieval on the SEC's website at [www.sec.gov](http://www.sec.gov). These SEC filings are also available to the public on (i) the Israel Securities Authority's Magna website at [www.magna.isa.gov.il](http://www.magna.isa.gov.il), (ii) the Tel Aviv Stock Exchange website at <http://www.maya.tase.co.il>, and (iii) from commercial document retrieval services. The documents referred to in this document may be inspected at the Company's offices, located at 8 Hanagar Street, Kfar Sava, Israel 4442537.

Any statement in this annual report about any of our contracts or other documents is not necessarily complete. If the contract or document is filed as an exhibit to the annual report the contract or document is deemed to modify the description contained in this annual report. We urge you to review the exhibits themselves for a complete description of the contract or document.

#### I. Subsidiary information

Not applicable

#### Item 11. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

Market risk is the risk of loss related to changes in market prices, including interest rates and foreign exchange rates, of financial instruments that may adversely impact our consolidated financial position, results of operations or cash flows. Our primary market risk exposures relate to our investment portfolio and fluctuation of the exchange rate of the US Dollar, which is the primary currency in which we conduct our operations, against the NIS.

##### Interest Rate Risk

As of December 31, 2012, our investment portfolio consisted of approximately \$41.1 million invested in corporate debt securities and government debt securities. These securities are classified as "held to maturity". All the Company's investments are currently in fixed-rate instruments, and in the past only a small portion of its investments (approximately 5%) were invested in variable-rate instruments. Therefore, the Company's exposure to interest rate risk from variable-rate instruments is generally very limited and not material to the Company. In addition, since the securities are "held to maturity", any changes in fair value of the Company's instruments due to fluctuations in the interest rates, that are not classified as OTTI, do not affect the Company's profit or loss.



For quantitative information on the Company's marketable securities, please see Note 4 to our consolidated financial statements included elsewhere in this annual report.

As of December 31, 2012 we did not have any short or long term interest bearing loans or debts, hence with respect to the Company's business operations, we do not have any exposure to interest rate risk.

#### Foreign Currency Exchange Risk

Most of our revenues are generated in U.S. dollars. In addition, most of our costs are denominated and determined in U.S. dollars and NIS. According to the salient economic factors indicated in ASC 830 "Foreign Currency Matters" (formerly SFAS No. 52), "Foreign Currency Translation," our cash flow, sale price, sales market, expense, financing and inter-company transactions, and arrangement indicators, are predominantly denominated in U.S. dollars, and so, the U.S. dollar is the primary currency of the economic environment in which we operate. Thus, the U.S. dollar is our functional and reporting currency. In our balance sheet, we re-measure into U.S. dollars all monetary accounts (principally cash and cash equivalents and liabilities) that are maintained in other currencies. For this re-measurement, we use the relevant foreign exchange rate at the balance sheet date. Any gain or loss that results from this re-measurement is reflected in the statement of operations as appropriate. We measure and record non-monetary accounts in our balance sheet in U.S. dollars. For this measurement, we use the U.S. dollar value in effect at the date that the asset or liability was initially recorded in our balance sheet (the date of the transaction).

As of December 31, 2012 we had accounts receivable in New Israeli Shekels (NIS) or in funds linked thereto in the amount of \$1,889 thousand. Market risk was estimated as the potential decrease in balance resulting from a hypothetical 10% increase in the year-end Dollar exchange rate. Assuming such increase in the Dollar exchange rate, the balance of our accounts receivable would decrease by \$172 thousand. As of December 31, 2012 we had accounts payable in New Israeli Shekels (NIS) or linked thereto in the amount of \$6,725 thousand. Market risk was estimated as the potential increase in balance resulting from a hypothetical 10% decrease in the year-end Dollar exchange rate. Assuming such decrease in the Dollar exchange rate, the balance of our accounts payable would increase by \$747 thousand.

In 2012 there was a decrease of 2.3% in the Dollar exchange rate to the New Israeli Shekel which resulted in an aggregate increase in the fair value of our assets of \$106 thousand and an aggregate increase in the fair value of our liabilities of \$192 thousand.

Since the majority of our revenues is denominated and paid in U.S. dollars, we believe that fluctuations in the U.S. dollar exchange rate do not have a significant effect on our accounts receivable. Inflation in Israel and the Israeli currency as well as U.S. dollar exchange rate fluctuations may have only a limited effect on our accounts payable, as described above.

Our operating expenses may be affected by fluctuations in the value of the U.S dollar as it relates to the NIS. By way of example, a hypothetical 10% weakening in the value of the dollar relative to the currencies in which our operating expenses are denominated in 2012 would have resulted in an increase in operating expenses of approximately \$825 thousand for the year ended December 31, 2012.

As of December 31, 2012, all of our investments, other than a portion of our cash and cash equivalents comprising a small portion of our overall investment portfolio, consisted of investments denominated in U.S. dollars, and our portfolio is therefore not subject to significant exposure to foreign currency exchange risk.

As of December 31, 2012, we were not engaged in any hedging or other transactions intended to manage the risks relating to foreign currency exchange rate or interest rate fluctuations.

#### Credit Risk

Our investment portfolio includes held to maturity marketable securities. These securities include investments issued by highly rated corporations or investments issued by agencies of governments. As of December 31, 2012, the rating of the securities in our portfolio was at least A-. Nonetheless, these investments are subject to general credit and counterparty risks (such as that the counterparty to a financial instrument fails to meet its contractual obligations), which were exacerbated by the recent turmoil that has affected the financial markets and the global economy and caused credit issues for a number of reputable financial institutions. Any changes in fair value of our investment securities due to credit risk do not affect our profit or loss unless there is other-than-temporary impairment (OTTI) (referred to in ASC 320-10 (formally known as FSP FAS 115-2) and ASC 958-320 (formally known as FAS 124-2).

As of December 31, 2012, we were not required to adjust the carrying value of our investment securities since there were no other-than-temporary impairments.

#### 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

None.

## Item 15. CONTROLS AND PROCEDURES

### Disclosure Controls and Procedures

We maintain disclosure controls and procedures that are designed to ensure that information required to be disclosed in its Exchange Act reports is recorded, processed, summarized and reported within the time periods specified in the Securities and Exchange Commission's rules and forms, and that such information is accumulated and communicated to our Chief Executive Officer and Chief Financial Officer to allow timely decisions regarding required disclosure. Our management, including our Chief Executive Officer and Chief Financial Officer, conducted an evaluation of our disclosure controls and procedures, as defined under Exchange Act Rule 13a-15(e) and Rule 15d-15(e), as of the end of the period covered by this Annual Report on Form 20-F. Based upon that evaluation, our Chief Executive Officer and Chief Financial Officer have concluded that, as of such date, our disclosure controls and procedures were effective.

### Management's Annual Report on Internal Control over Financial Reporting

Our management is responsible for establishing and maintaining adequate internal control over financial reporting (as defined in Rules 13a-15(f) and 15d-15(f) under the Exchange Act) to provide reasonable assurance regarding the reliability of our financial reporting and the preparation of financial statements for external purposes in accordance with U.S. generally accepted accounting principles.

Management assessed our internal control over financial reporting as of December 31, 2012, the end of our fiscal year. In making this assessment, management used the criteria set forth by the Committee of Sponsoring Organizations of the Treadway Commission (COSO) in "Internal Control —Integrated Framework."

Based on our assessment, management has concluded that our internal control over financial reporting was effective as of December 31, 2012 to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external reporting purposes in accordance with U.S. generally accepted accounting principles. We reviewed the results of management's assessment with the Audit Committee of our Board of Directors.

This annual report includes, on page F-2 of this form 20-F, an attestation report of the Company's registered public accounting firm on management's assessment of the Company's internal control over financial reporting.

### Inherent Limitations on Effectiveness of Controls

Internal control over financial reporting has inherent limitations. Internal control over financial reporting is a process that involves human diligence and compliance and is subject to lapses in judgment and breakdowns resulting from human failures. Internal control over financial reporting also can be circumvented by collusion or improper management override. Because of such limitation, there is a risk that material misstatements will not be prevented or detected on a timely basis by internal control over financial reporting. However, these inherent limitations are known features of the financial reporting process. Therefore, it is possible to design into the process safeguards to reduce, though not eliminate, this risk.

### Changes in Internal Control over Financial Reporting

There was no change in our internal controls over financial reporting that occurred during the period covered by this annual report that has materially affected, or is reasonably likely to materially affect, our internal controls over financial reporting.

### Item 15T. CONTROLS AND PROCEDURES

Not Applicable.

### Item 16. Reserved

### Item 16A. AUDIT COMMITTEE FINANCIAL EXPERT

Our board of directors has determined that both Ms. Einat Domb-Har and Mr. Ilan Erez are our audit committee financial experts, and that Ms. Domb-Har and Mr. Erez are independent as such term is defined under the NASDAQ Capital Market listing requirements. Our board of directors has also made such determinations with respect to Ms. Ayelet Aya Hayak, the nominee for external director proposed to be approved by the shareholders at the Annual General Meeting of the shareholders on April 10, 2013, as a replacement for Ms. Domb-Har as of July 1, 2013 when Ms. Domb-Har's third and final three-year term as an external director expires.

### Item 16B. CODE OF ETHICS

Our company has adopted a code of ethics, which applies to all of our employees, officers and directors, including our Chief Executive Officer, our Chief Financial Officer and our principal accountant. A copy of the code of ethics is attached as an exhibit to this annual report.

### Item 16C. PRINCIPAL ACCOUNTANT FEES AND SERVICES

The following table presents fees for professional services for the audit of the Company's consolidated annual financial statements for the years ended December 31, 2012 and 2011, audit-related services and tax services rendered by Somekh Chaikin, a member firm of KPMG International.

	2011	2012
Audit Fees(1)	\$105,000	\$105,000
Audit-Related Fees(2)	-	\$33,000
Tax Fees(3)	\$8,000	\$38,000

(1) Audit fees consist of fees for professional services rendered for the audit of the Company's annual consolidated financial statements and services normally provided by the independent auditor in connection with statutory and regulatory filings or engagements.

(2) Audit-Related Fees consist of accounting consultation and consultation on financial accounting standards, not arising as part of the audit.

(3) Tax Fees are the aggregate fees billed for professional services rendered for tax compliance, tax advice, other than in connection with the Audit. Tax compliance involves audit of original and amended tax returns, tax planning and tax advice.



Audit committee's pre-approval policies and procedures

We are required to obtain the approval of our audit committee (and subsequently the consent of the board of directors and shareholders) before engaging our independent auditors, Somekh Chaikin, a member firm of KPMG International, to audit our consolidated financial statements, as well as to provide other audit or permitted non-audit services to us. This policy, which is designed to assure that such engagements do not impair the independence of our auditors, requires pre-approval from the audit committee on an annual basis for the various audit and non-audit services that may be performed by our auditors. Our audit committee is not permitted to approve the engagement of our auditors for any services that would be inconsistent with maintaining the auditor's independence or that are not permitted by applicable law.

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

Not Applicable.

Item 16E. PURCHASES OF EQUITY SECURITIES BY THE ISSUER AND AFFILIATED PURCHASERS

Not Applicable.

Item 16F. CHANGE IN REGISTRANT'S CERTIFYING ACCOUNTANT

Not Applicable.

Item 16G. CORPORATE GOVERNANCE

Our corporate governance practices differ from those followed by domestic companies as required under the listing standards of the NASDAQ Global Market, due to an exemption that we obtained from NASDAQ as foreign private issuer which enables us to comply with our home country laws of the State of Israel in lieu of NASDAQ Listing Rules. We follow the provisions of the Israeli Companies Law – 1999 with respect to the following:

- We are not required to distribute annual and quarterly reports directly to shareholders, but we do make our audited financial statements available to our shareholders prior to our annual general meeting and furnish our quarterly and annual financial results with the Securities and Exchange Commission on Form 6-K.

- A majority of our board of directors is not comprised of independent directors as defined in the NASDAQ Listing Rules, but our board of directors contains two external directors in accordance with the Israeli Companies Law – 1999. Israeli law does not require, nor do our external directors conduct, regularly scheduled meetings at which only they are present. In addition, with the exception of our external directors, our directors are elected for terms of one year or until the following annual meeting, by a general meeting of our shareholders. The nominations for director which are presented to our shareholders are also generally made by our directors. Pursuant to the Amendment, one or more shareholders of a company holding at least one percent of the voting power of the company may nominate a currently serving external director for an additional three year term. Israeli law does not require the adoption of and our board has not adopted a formal written charter or board resolution addressing the nomination process and related matters. Compensation of our directors and other officers is determined in accordance with Israeli law.
- Our audit committee has not adopted a formal written audit committee charter specifying the items enumerated in NASDAQ Listing Rule 5605(c)(1). We believe that the members of our audit committee comply with the requirements of the Israeli law, as well as NASDAQ Listing Rule 5605(c)(3) and Rule 10A-3(b) of the general rules and regulations promulgated under the Securities Act of 1933. For a detailed discussion please refer to "Item 6. Directors, Senior Management and Employees- Audit Committee".
- As opposed to NASDAQ Listing Rule 5620(c)(3), which sets forth a minimum quorum for a shareholders meeting, under Israeli law a company is entitled to determine in its articles of association the number of shareholders and percentage of holdings required for a quorum at a shareholders meeting. Our current articles of association provide that a quorum of two or more shareholders, present in person or by proxy, holding shares conferring in the aggregate more than thirty three and a third (33 1/3 %) percent of the voting power of the Company is required.
- All related party transactions are approved in accordance with the requirements and procedures for approval of interested party acts and transactions set forth in the Israeli Companies Law-1999, and are not subject to the review process set forth in NASDAQ Listing Rule 5630. For a detailed discussion please refer to "Item 10. Additional Information- the Israeli Companies Law-1999".
- We seek shareholder approval for all corporate action requiring such approval in accordance with the requirements of the Israeli Companies Law – 1999 rather than under the requirements of the NASDAQ Marketplace Rules, including (but not limited to) the appointment or termination of auditors, appointment and dismissal of directors, approval of interested party acts and transactions requiring general meeting approval as discussed above and a merger.

Item 16H. MINE SAFETY DISCLOSURE

Not Applicable.

PART III.

Item 17. FINANCIAL STATEMENTS

Not Applicable

Item 18. FINANCIAL STATEMENTS

See pages F-1 to F-37.

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Item 19. EXHIBITS

- 1.1 Amended and Restated Articles of Association, adopted on January 24, 2008, filed by us as an Exhibit to our registration statement on Form S-8, as filed with the Securities and Exchange Commission on February 11, 2008, and incorporated herein by reference.
- 1.2 Amendment to Articles of Association of the Registrant incorporated by reference to Proposal 5 found in Exhibit 2 to the Form 6-K as filed with the Securities and Exchange Commission on March 1, 2012, and incorporated herein by reference
- 4.1 Lease between the Company and Yaakov Metzkin and Dov Segev, for premises in Kfar Sava, Israel, dated November 1, 1994, and amendment dated March 17, 2002, filed by us as an Exhibit to our annual report on Form 20-F for the fiscal year ended December 31, 2001, as filed with the Securities and Exchange Commission on June 27, 2002, and incorporated herein by reference. As this lease and the amendment are written in Hebrew, a summary of each was included in the Exhibit.
- 4.2 Lease between the Company and Naji Yechezkel Yokenam Industrial Center Ltd. for manufacturing facility in Yokneam, Israel, dated November 20, 2008 filed by us as an Exhibit to our annual report on Form 20-F for the fiscal year ended December 31, 2008, as filed with the Securities and Exchange Commission on March 23, 2009, and incorporated herein by reference. As this lease is written in Hebrew, a summary was included in the Exhibit.
- 4.3 Lease between Silicom Connectivity Solutions, Inc. and RAD Data Communications Inc., for space in Mahwah, New Jersey, dated as of September 1, 1997, filed by us as an Exhibit to our annual report on Form 20-F for the fiscal year ended December 31, 2000, as filed with the Securities and Exchange Commission on June 30, 2001, and incorporated herein by reference.
- 4.4 Sublease Agreement between Silicom Connectivity Solutions, Inc. and Radcom Equipmet, Inc., for space in Paramus, New Jersey, dated as of February 1, 2004, filed by us as an Exhibit to our annual report on Form 20-F for the fiscal year ended December 31, 2003, as filed with the Securities and Exchange Commission on June 30, 2004, and incorporated herein by reference.
8. List of subsidiaries, filed by us as an Exhibit to our annual report on Form 20-F for the fiscal year ended December 31, 2000, as filed with the Securities and Exchange Commission on June 30, 2001, and incorporated herein by reference.
- 11.1 Code of Ethics, filed by us as an Exhibit to our annual report on Form 20-F for the fiscal year ended December 31, 2007, as filed with the Securities and Exchange Commission on March 26, 2008, and incorporated herein by reference.
- 12.1 Certification by Chief Executive Officer pursuant to section 302 of the Sarbanes-Oxley Act of 2002.
- 12.2 Certification by Chief Financial Officer pursuant to section 302 of the Sarbanes-Oxley Act of 2002.
- 13.1 Certification by Chief Executive Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
- 13.2 Certification by Chief Financial Officer Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
- 15.1 Consent of Somekh Chaikin, Independent Registered Public Accounting Firm, a member firm of KPMG International.



SIGNATURES

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.

SILICOM LIMITED

By: /s/ Shaike Orbach  
Shaike Orbach  
Chief Executive Officer

March 21, 2013

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Silicom Ltd.  
and its Subsidiary  
Consolidated  
Financial Statements

As of and for the year ended December 31, 2012

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Consolidated Financial Statements as of December 31, 2012

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Report of Independent Registered Public Accounting Firm

To Board of Directors and Shareholders  
Silicom Ltd.:

We have audited the accompanying consolidated balance sheets of Silicom Ltd. and its subsidiary (hereinafter - “the Company”) as of December 31, 2011 and 2012 and the related consolidated statements of operations, changes in shareholders’ equity and cash flows for each of the years in the three-year period ended December 31, 2012. We also have audited the Company’s internal control over financial reporting as of December 31, 2012, based on criteria established in Internal Control - Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (“COSO”). The Company’s management is responsible for these consolidated financial statements, for maintaining effective internal control over financial reporting, and for its assessment of the effectiveness of internal control over financial reporting, included in the accompanying Management’s Annual Report on Internal Control Over Financial Reporting. Our responsibility is to express an opinion on these consolidated financial statements and an opinion on the Company’s internal control over financial reporting 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 audits to obtain reasonable assurance about whether the financial statements are free of material misstatement and whether effective internal control over financial reporting was maintained in all material respects. Our audits of the consolidated financial statements included examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. Our audit of internal control over financial reporting included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, and testing and evaluating the design and operating effectiveness of internal control based on the assessed risk. Our audits also included performing such other procedures as we considered necessary in the circumstances. We believe that our audits provide a reasonable basis for our opinions.

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, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of the Company as of December 31, 2011 and 2012, and the results of their operations and their cash flows for each of the years in the three-year period ended December 31, 2012, in conformity with U.S. generally accepted accounting principles. Also in our opinion, the Company maintained, in all material respects, effective internal control over financial reporting as of December 31, 2012, based on criteria established in Internal Control - Integrated Framework issued by the COSO.

Somekh Chaikin

Certified Public Accountants (Isr.)  
Member Firm of KPMG International

Tel Aviv, Israel  
March 18, 2013

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Silicom Ltd. and its Subsidiary

## Consolidated Balance Sheets as of December 31

	Note	2011 US\$ thousands	2012 US\$ thousands
<b>Assets</b>			
<b>Current assets</b>			
Cash and cash equivalents	3	11,483	13,306
Short-term bank deposits	2E	5,010	2,527
Marketable securities	2F, 4	9,027	12,583
Accounts receivable:			
Trade, net	2G	8,405	12,146
Other		1,597	2,234
Related parties		208	245
Inventories	5	11,173	14,795
Deferred tax assets	12H	48	47
<b>Total current assets</b>		<b>46,951</b>	<b>57,883</b>
Marketable securities	2F, 4	23,667	28,469
Assets held for employees' severance benefits	7	1,275	1,377
Deferred tax assets	12H	135	114
Property, plant and equipment, net	6	837	1,190
<b>Total assets</b>		<b>72,865</b>	<b>89,033</b>

Avi Eizenman  
Chairman of the Board of  
Directors

Shaiké Orbach  
Chief Executive Officer

Eran Gilad  
Chief Financial Officer

Kfar-Saba, Israel  
March 18, 2012

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



## Consolidated Balance Sheets as of December 31 (Continued)

	Note	2011 US\$ thousands	2012 US\$ thousands
<b>Liabilities and shareholders' equity</b>			
<b>Current liabilities</b>			
Trade accounts payable		3,971	7,799
Other accounts payable and accrued expenses		2,460	3,914
Related parties		7	76
<b>Total current liabilities</b>		<b>6,438</b>	<b>11,789</b>
<b>Long-term liability</b>			
Liability for employees' severance benefits	7	2,153	2,278
<b>Total liabilities</b>		<b>8,591</b>	<b>14,067</b>
<b>Commitments and contingencies</b>	8		
<b>Shareholders' equity</b>	9		
Ordinary shares, NIS 0.01 par value; 10,000,000 shares authorized; 6,940,059 and 7,022,397 issued as at December 31, 2011 and 2012, respectively; 6,925,088 and 7,007,426 outstanding as at December 31, 2011 and 2012, respectively		20	21
Additional paid-in capital		35,245	36,065
Treasury shares (at cost) - 14,971 ordinary shares as at December 31, 2011 and 2012		(38 )	(38 )
Retained earnings		29,047	38,918
<b>Total shareholders' equity</b>		<b>64,274</b>	<b>74,966</b>
<b>Total liabilities and shareholders' equity</b>		<b>72,865</b>	<b>89,033</b>

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

Silicom Ltd. and its Subsidiary

## Consolidated Statements of Operations for the Year Ended December 31

		2010	2011	2012
		US\$ thousands		
	Note	Except for share and per share data		
Sales*	10	30,399	39,633	48,729
Cost of sales		17,490	22,430	28,849
Gross profit		12,909	17,203	19,880
Operating expenses				
Research and development**		3,280	4,165	4,401
Sales and marketing		2,207	2,677	3,081
General and administrative		1,523	1,890	2,369
Total operating expenses		7,010	8,732	9,851
Operating income		5,899	8,471	10,029
Financial income, net	11	617	439	752
Income before income taxes		6,516	8,910	10,781
Income taxes	12	801	667	910
Net income		5,715	8,243	9,871
Income per share:				
Basic income per ordinary share (US\$)	2S	0.838	1.195	1.424
Diluted income per ordinary share (US\$)		0.824	1.178	1.417
Weighted average number of ordinary shares used to compute basic income per share (in thousands)		6,821	6,896	6,934
Weighted average number of ordinary shares used to compute diluted income per share (in thousands)		6,938	6,995	6,968

\* Including sales to related parties in the amount of US\$ 302 thousand, US\$ 350 thousand and US\$ 558 thousand in 2010, 2011 and 2012, respectively.

\*\* Including services from related parties in the amount of US\$ 154 thousand, US\$ 50 thousand and US\$ 42 thousand in 2010, 2011 and 2012, respectively.

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



## Consolidated Statements of Changes in Shareholders' Equity

	Ordinary shares		Additional paid-in capital	Treasury shares	Retained earnings	Total shareholders' Equity
	Number of shares(1)		US\$ thousands			
Balance at January 1, 2010	6,809,313	20	34,154	(38 )	15,089	49,225
Exercise of options	70,375	*-	259	-	-	259
Share-based compensation	-	-	231	-	-	231
Net income	-	-	-	-	5,715	5,715
Balance at December 31, 2010	6,879,688	20	34,644	(38 )	20,804	55,430
Exercise of options	45,400	*-	164	-	-	164
Share-based compensation	-	-	437	-	-	437
Net income	-	-	-	-	8,243	8,243
Balance at December 31, 2011	6,925,088	20	35,245	(38 )	29,047	64,274
Exercise of options	82,338	1	276	-	-	277
Share-based compensation	-	-	544	-	-	544
Net income	-	-	-	-	9,871	9,871
Balance at December 31, 2012	7,007,426	21	36,065	(38 )	38,918	74,966

(1) Net of 14,971 shares held by the subsidiary

\* Less than 1 thousand.

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

## Consolidated Statements of Cash Flows for the Year Ended December 31

	2010	2011	2012
	US\$ thousands		
<b>Cash flows from operating activities</b>			
Net income	5,715	8,243	9,871
Adjustments required to reconcile net income to net cash provided by operating activities:			
Depreciation	416	379	454
Write-down of obsolete inventory	780	768	873
Liability for employees' severance benefits, net	58	(42)	23
Discount of marketable securities	467	462	579
Share-based compensation expense	231	437	544
Deferred taxes	156	86	22
Capital (gain) loss	2	(6)	-
Changes in assets and liabilities:			
Accounts receivable – trade	(1,573)	(1,780)	(3,741)
Accounts receivable - other	(184)	(717)	(537)
Accounts receivable – Related parties	(17)	(71)	(37)
Inventories	(4,243)	(3,801)	(4,495)
Trade accounts payable	1,467	250	3,828
Other accounts payable and accrued expenses	51	508	1,436
Accounts payable – Related parties	25	(25)	69
Net cash provided by operating activities	3,351	4,691	8,889
<b>Cash flows from investing activities</b>			
Proceeds from (investments in) short term bank deposits, net	(1,956)	4,199	2,483
Purchases of property, plant and equipment	(466)	(486)	(798)
Proceeds from maturity of marketable securities	11,303	9,531	8,955
Purchases of marketable securities	(12,972)	(13,071)	(17,992)
Net cash provided by (used in) investing activities	(4,091)	173	(7,352)
<b>Cash flows from financing activities</b>			
Exercise of options	259	164	277
Net cash provided by financing activities	259	164	277
Effect of exchange rate changes on cash balances held	(115)	(202)	9
Increase (decrease) in cash and cash equivalents	(596)	4,826	1,823
Cash and cash equivalents at beginning of year	7,253	6,657	11,483
Cash and cash equivalents at end of year	6,657	11,483	13,306

## Supplementary cash flow information

## A. Non-cash transactions:

Investments in fixed assets	-	80	9
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## B. Cash paid during the year for:

Income taxes	1,148	623	635
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The accompanying notes are an integral part of these consolidated financial statements.

Notes to the Consolidated Financial Statements

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## Note 1 - General

Silicom Ltd. is an Israeli corporation engaged in designing, manufacturing, marketing and supporting server networking solutions for a broad range of servers and server based systems.

The Company's shares have been traded in the United States on the National Association of Securities Dealers Automated Quotation System ("NASDAQ"), since February 1994 and in Israel on the Tel Aviv Stock Exchange ("TASE"), since December 2005. Since February 11, 2008, the Company's shares have been traded on the NASDAQ Global Market (prior thereto they were traded on the NASDAQ Capital Market).

Silicom markets its products directly, through (i) Original Equipment Manufacturers ("OEMs") which sell the Company's connectivity products under their own private labels or incorporate the Company's products into their products, (ii) a worldwide network of independent distributors and (iii) its US-based subsidiary.

In these financial statements the terms "Company" or Silicom refer to Silicom Ltd. and its wholly owned subsidiary, Silicom Connectivity Solutions, Inc., whereas the term "subsidiary" refers to Silicom Connectivity Solutions, Inc.

## Note 2 - Summary of Significant Accounting Policies

The significant accounting policies, which are applied consistently throughout the periods presented, are as follows:

## A. Financial statements in US dollars

Substantially all sales of the Company are made outside of Israel (see Note 10A regarding geographical distribution), in US dollars ("dollars"). Most purchases of materials and components, and a significant part of the marketing costs are made or incurred, primarily in dollars. Therefore, the functional currency of the Company is the dollar.

Transactions and monetary balances in other currencies are translated into the functional currency using the current exchange rate.

All exchange gains and losses from remeasurement of monetary balance sheet items denominated in non-dollar currencies are reflected in earnings when they arise.

## B. Basis of presentation

The accompanying consolidated financial statements have been prepared with accounting principles generally accepted in the United States of America and include the accounts of the Company and its wholly-owned subsidiary in the United States. All intercompany balances and transactions have been eliminated in consolidation.

Notes to the Consolidated Financial Statements

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## Note 2 - Summary of significant Accounting Policies (cont'd)

## C. Estimates and assumptions

The preparation of the consolidated financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the consolidated financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates. Significant items subject to such estimates and assumptions include the useful lives of fixed assets; allowances for doubtful accounts, deferred tax assets, fixed assets, inventory, investments, share-based compensation, income tax uncertainties and other contingencies.

## D. Cash and cash equivalents

The Company considers highly liquid investments with original maturities of three months or less from the date of deposit to be cash equivalents.

## E. Short-term bank deposits

Short term bank deposits consist of bank deposits with original maturities of more than three months and up to twelve months.

As of December 31, 2012 the Company's short-term bank deposits consist of bank deposits in US dollars that bear fixed annual interest of 1.81% (2011 1.70%-1.90%). These short-term bank deposits are held with a major Israeli bank, and their use and withdrawal are not subject to any restrictions.

## F. Marketable securities

Investment securities at December 31, 2011 and 2012 consist of corporate debt and government debt.

The Company classifies its marketable securities as held-to-maturity as they are debt securities in which the Company has the intent and ability to hold to maturity. Held-to-maturity (HTM) debt securities are recorded at amortized cost adjusted for the amortization or accretion of premiums or discounts.

Premiums and discounts on debt securities are amortized or accreted over the life of the related held-to-maturity security as an adjustment to yield using the effective interest method. Such amortization and accretion is included in the "Financial income, net" line item in the consolidated statements of operations.

When other-than-temporary impairment has occurred, the amount of the other-than-temporary impairment recognized in earnings depends on whether the Company intends to sell the security or it is more likely than not that it will be required to sell the security before recovery of its amortized cost basis less any current-period credit loss.





Notes to the Consolidated Financial Statements

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## Note 2 - Summary of Significant Accounting Policies (cont'd)

## F. Marketable securities (cont'd)

A decline in the market value of HTM security below cost that is deemed to be other than temporary results in an impairment to reduce the carrying amount to fair value. To determine whether an impairment is other than temporary, the Company considers all available information relevant to the collectibility of the security, including past events, current conditions, and reasonable and supportable forecasts when developing estimate of cash flows expected to be collected. Evidence considered in this assessment includes the reasons for the impairment, the severity and duration of the impairment, changes in value subsequent to year end, forecasted performance of the investee, and the general market condition in the geographic area or industry the investee operates in.

If the Company intends to sell the security or it is more likely than not will be required to sell the security before recovery of its amortized cost basis less any current-period credit loss, the other-than-temporary impairment is recognized in earnings equal to the entire difference between the investment's amortized cost basis and its fair value at the balance sheet date. If the Company does not intend to sell the security and it is not more likely than not that the Company will be required to sell the security before recovery of its amortized cost basis less any current-period credit loss, the other-than-temporary impairment is separated into the amount representing the credit loss and the amount related to all other factors. The amount of the total other-than-temporary impairment related to the credit loss is recognized in earnings.

## G. Trade accounts receivable, net

Trade accounts receivable are recorded at the invoiced amount and do not bear interest. Amounts collected on trade accounts receivable are included in net cash provided by operating activities in the Consolidated Statements of Cash Flows. The Company maintains an allowance for doubtful accounts for estimated losses inherent in its accounts receivable portfolio. In establishing the required allowance, management considers historical losses adjusted to take into account current market conditions and its customers' financial condition, the amount of receivables in dispute, and the current receivables aging and current payment patterns.

As of December 31, 2011 and 2012, the provision for doubtful accounts receivable amounted to US\$ 20 thousand.

## H. Inventories

Inventories are stated at the lower of cost or market. Cost is determined using the "average-cost" method.

The Company writes down obsolete or slow moving inventory to its market value, on a quarterly basis.

## Notes to the Consolidated Financial Statements

## Note 2 - Summary of Significant Accounting Policies (cont'd)

## I. Assets held for employees' severance benefits

Assets held for employees' severance benefits represent contributions to severance pay funds and cash surrender value of insurance policies. The assets are recorded at their current cash redemption value.

## J. Property, plant and equipment

Property, plant and equipment are stated at cost. Depreciation is calculated on the straight-line basis over the estimated useful life of the assets at the following annual rates:

	%
Machinery and equipment	15 - 33
Office furniture and equipment	6 - 33
Leasehold improvements	10 - 20

## K. Long lived assets

In accordance with Impairment or Disposal of Long-Lived Assets Subsections of FASB ASC Subtopic 360-10, Property, Plant, and Equipment - Overall long-lived assets, such as property, plant, and equipment, are reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. If circumstances require a long-lived asset or an asset group to be tested for possible impairment, the Company first compares undiscounted cash flows expected to be generated by that asset or asset group to its carrying value. If the carrying value of the long-lived asset or asset group is not recoverable on an undiscounted cash flow basis, an impairment is recognized to the extent that the carrying value exceeds its fair value.

## L. Revenue recognition

Revenues from sales of products are recognized upon delivery provided that the collection of the resulting receivable is reasonably assured, there is persuasive evidence of an arrangement, no significant obligations in respect of installation remain and the price is fixed or determinable.

Sales taxes collected from customers and remitted to governmental authorities are accounted for on a net basis and, therefore, are excluded from revenues in the consolidated statements of income.

## M. Research and development costs

Research and development costs are expensed as incurred.

Notes to the Consolidated Financial Statements

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## Note 2 - Summary of Significant Accounting Policies (cont'd)

## N. Royalty bearing participations

Royalty bearing participation from the Government of Israel for funding research and development activities are recognized at the time the Company is entitled to such grants based on the related cost incurred. See also Note 8A.

Royalty expenses are recognized pursuant to the sale of related products and are classified as cost of sales.

## O. Allowance for product warranty

The Company grants service warranties related to certain products to end-users. The Company estimates its obligation for such warranties to be immaterial on the basis of historical experience. Accordingly, these financial statements do not include an accrual for warranty obligations.

## P. Treasury shares

Treasury shares are recorded at cost and presented as a reduction of shareholders' equity.

## Q. Income taxes

Deferred taxes are accounted for under the asset and liability method based on the estimated future tax effects of temporary differences between the financial statements carrying amounts of existing assets and liabilities and their respective tax bases, and operating loss and tax credit carryforwards. Deferred tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. The effect on deferred tax assets and liabilities of a change in tax rates is recognized in the consolidated statements of operations in the period that includes the enactment date. The Company provides a valuation allowance to reduce deferred tax assets to the extent it believes it is more likely than not that such benefits will not be realized. Deferred tax assets and liabilities are classified as current or non-current based on the classification of the related asset or liability for financial reporting, or according to the expected reversal dates of the specific temporary differences where appropriate. The Company recognizes the effect of income tax positions only if those positions are more likely than not of being sustained. Recognized income tax positions are measured at the largest amount that is greater than 50% likely of being realized. Changes in recognition or measurement are reflected in the period in which the change in judgment occurs. The Company records interest related to unrecognized tax benefits in interest expense and penalties in general and administrative expenses.

## Notes to the Consolidated Financial Statements

## Note 2 - Summary of Significant Accounting Policies (cont'd)

## R. Share-based compensation

The Company recognizes compensation expense based on estimated grant date fair value in accordance with ASC Topic 718, Compensation -Stock Compensation as follows:

When portions of an award vest in increments during the requisite service period (graded-vesting award), the Company's accounting policy is to recognize compensation cost for the award over the requisite service period for each separately vesting portion of the award.

## S. Income per ordinary share

Basic income per ordinary share is calculated by dividing the net income attributable to ordinary shares, by the weighted average number of ordinary shares outstanding. Diluted income per ordinary share calculation is similar to basic income per ordinary share except that the weighted average of common shares outstanding is increased to include outstanding potential common shares during the period if dilutive. Potential common shares arise from stock options and the dilutive effect is reflected by the application of the treasury stock method.

The following table summarizes information related to the computation of basic and diluted income per ordinary share for the years indicated.

	Year ended December 31		
	2010	2011	2012
Net income attributable to ordinary shares (US\$ thousands)	5,715	8,243	9,871
Weighted average number of ordinary shares outstanding used in basic income per ordinary share calculation	6,820,721	6,896,215	6,933,576
Add assumed exercise of outstanding dilutive potential ordinary shares	117,735	98,377	34,729
Weighted average number of ordinary shares outstanding used in diluted income per ordinary share calculation	6,938,456	6,994,592	6,968,305
Basic income per ordinary shares (US\$)	0.838	1.195	1.424
Diluted income per ordinary shares (US\$)	0.824	1.178	1.417

Number of options and warrants excluded from the diluted earnings per share calculation because of anti-dilutive effect	137,500	135,000	135,000
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T. Comprehensive Income

For the year ended December 31, 2010, 2011 and 2012, comprehensive income is equals to net income.

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Notes to the Consolidated Financial Statements

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## Note 2 - Summary of Significant Accounting Policies (cont'd)

## U. Fair Value Measurements

The Company's financial instruments include mainly cash and cash equivalents, accounts receivable, short term bank deposits, marketable securities and accounts payable. The carrying amounts of these financial instruments approximate their fair value. For marketable securities fair value see Note 4.

The Company utilizes valuation techniques that maximize the use of observable inputs and minimize the use of unobservable inputs to the extent possible. The Company determines fair value based on assumptions that market participants would use in pricing an asset or liability in the principal or most advantageous market. When considering market participant assumptions in fair value measurements, the following fair value hierarchy distinguishes between observable and unobservable inputs, which are categorized in one of the following levels:

Level 1 Inputs: Unadjusted quoted prices in active markets for identical assets or liabilities accessible to the reporting entity at the measurement date.

Level 2 Inputs: Other than quoted prices included in Level 1 inputs that are observable for the asset or liability, either directly or indirectly, for substantially the full term of the asset or liability.

Level 3 Inputs: Unobservable inputs for the asset or liability used to measure fair value to the extent that observable inputs are not available, thereby allowing for situations in which there is little, if any, market activity for the asset or liability at measurement date.

In May 2011, the FASB issued ASU 2011-04, Fair Value Measurement (Topic 820): Amendments to Achieve Common Fair Value Measurement and Disclosure Requirements in U.S. GAAP and IFRS. The new standards do not extend the use of fair value but, rather, provide guidance about how fair value should be applied where it already is required or permitted under IFRS or U.S. GAAP. For U.S. GAAP, most of the changes are clarifications of existing guidance or wording changes to align with IFRS. The provisions of the ASU are effective for reporting periods beginning after December 15, 2011. The Company adopted the provision of the ASU in 2012. The adoption of the ASU 2011-04 did not have a material effect on the Company's consolidated financial statements.

## V. Recently Issued Accounting Standards

In December 2011, the FASB issued ASU No. 2011-11, Balance Sheet (Topic 210): Disclosures about Offsetting Assets and Liabilities. ASU 2011-11 requires an entity to disclose information about offsetting and related arrangements to enable users of financial statements to understand the effect of those arrangements on its financial position, and to allow investors to better compare financial statements prepared under U.S. GAAP with financial statements prepared under International Financial Reporting Standards (IFRS). The new standard is effective for annual periods beginning January 1, 2013, and interim periods within the annual period. Retrospective application is required. The Company will implement the provisions of ASU 2011-11 as of January 1, 2013. The adoption of the ASU 2011-11 will not have a material effect on the Company's consolidated financial statements.





## Notes to the Consolidated Financial Statements

## Note 2 - Summary of Significant Accounting Policies (cont'd)

W.	Concentrations of risks
(1)	Credit risk

Financial instruments, which potentially subject the Company to significant concentrations of credit risk, consist principally of cash and cash equivalents, short-term bank deposits, marketable securities, trade receivables and assets held for employees' severance benefits. Cash and cash equivalents balances of the Company, which are subject to credit risk, consist of cash accounts held with major financial institutions. Short-term bank deposits balances of the Company, which are subject to credit risk, consist of short-term bank deposits held with a major Israeli Bank. Marketable securities include held to maturity marketable securities issued by highly rated corporations or governmental securities. As of December 31, 2011 and 2012, the rating of the securities in the Company's portfolio was at least A-. Nonetheless, these investments are subject to general credit and counterparty risks (such as that the counterparty to a financial instrument fails to meet its contractual obligations). Any changes in fair value of the Company's investment securities due to credit risk do not affect the Company's profit or loss unless there is other-than-temporary impairment (OTTI).

Concentrations of credit risk with respect to trade receivables are limited due to the Company's diverse customer base and their wide geographical dispersion. The Company closely monitors extensions of credit and has never experienced significant credit losses.

(2)	Concentrations of trade accounts payable
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Certain key components used in the Company's products are currently available from only one source and others are available from a limited number of sources. The Company believes it maintains sufficient inventory of these components to protect against delays in deliveries.

(3)	Dominant single product line
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The Company depends to a great extent on one line of products for most of its revenues. The majority of the Company's current business is based on its Multi-Port Gigabit-Ethernet Server Adapter product line and the majority of its revenue is generated from that product line.

(4)	Dominant customers
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The Company depends on a small amount of customers for its products. The Company's top two customers accounted for approximately 40% of its revenues in 2012. The Company expects that a small number of customers will continue to account for a significant portion of its revenues for the foreseeable future.

#### X. Liabilities for loss contingencies

Liabilities for loss contingencies arising from claims, assessments, litigation, fines, and penalties and other sources are recorded when it is probable that a liability has been incurred and the amount can be reasonably estimated. Legal costs

incurred in connection with loss contingencies are expensed as incurred.

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## Notes to the Consolidated Financial Statements

## Note 3 - Cash and Cash Equivalents

	December 31	
	2011	2012
	US\$ thousands	
Cash	6,461	13,248
Cash equivalents *	5,022	58
	11,483	13,306

\*Comprised mainly of deposits in banks as at December 31, 2011 and 2012 carrying a weighted average interest rate of 1.79% and 0.11%, respectively.

## Note 4 - Marketable Securities

The Company's investment in marketable securities as of December 31, 2011 and 2012 are classified as "held-to-maturity" and consist of the following:

	Aggregate cost basis**	Gross unrealized holding gains US\$ thousands	Gross unrealized holding (losses)	Aggregate fair value*
<b>At December 31, 2011</b>				
Held to maturity:				
Corporate debt securities and government debt securities				
Current	9,108	5	(100 )	9,013
Non-Current	23,911	-	(452 )	23,459
	33,019	5	(552 )	32,472
<b>At December 31, 2012</b>				
Held to maturity:				
Corporate debt securities and government debt securities				
Current	12,702	23	(56 )	12,669
Non-Current	28,775	193	(126 )	28,842
	41,477	216	(182 )	41,511

\* Fair value is being determined using quoted market prices in active markets (Level 1).

\*\* Including accrued interest in the amount of \$325K and \$425K as of December 31, 2011 and 2012 respectively.



## Notes to the Consolidated Financial Statements

## Note 4 - Marketable Securities (Cont'd)

The amortized cost, gross unrealized losses and fair value of the debt securities by major interest type were as follows:

	December 31, 2011		
	Amortized	Net unrealized holding gains/(losses)	Fair value
	cost	US\$ thousands	
Up to 2%	25,225	(415 )	24,810
2.038% - 2.874%	7,794	(132 )	7,662
	33,019	(547 )	32,472

	December 31, 2012		
	Amortized	Net unrealized holding gains/(losses)	Fair value
	cost	US\$ thousands	
Up to 2%	33,145	(84 )	33,061
2.038% - 2.951%	8,332	118	8,450
	41,477	34	41,511

## Activity in Marketable securities in 2012

	US\$ thousands
Balance at January 1, 2012	33,019
Purchases of marketable securities	17,992
Discount of marketable securities	(579 )
Proceeds from maturity of marketable securities	(8,955 )
Balance at December 31, 2012	41,477

## Notes to the Consolidated Financial Statements

## Note 4 - Marketable Securities (Cont'd)

The following table summarizes the gross unrealized losses on investment securities for which other-than-temporary impairments have not been recognized and the fair value of those securities, aggregated by investment category and length of time that individual securities have been in a continuous unrealized loss position, at December 31, 2012:

Held to maturity	Less than 12 months		12 months or more		Total	
	Unrealized Losses	Fair value	Unrealized Losses	Fair value	Unrealized Losses	Fair value
Corporate debt securities and government debt securities	(106 )	6,803	(76 )	10,701	(182 )	17,504

The unrealized losses on the investments were caused by interest rate increases. The Company has the ability and intent to hold these investments until maturity and it is more likely than not that the Company will not be required to sell any of the securities before recovery; therefore these investments are not considered other than temporarily impaired.

## Note 5 - Inventories

	December 31	
	2011	2012
	US\$ thousands	
Raw materials and components	3,885	5,971
Products in process	5,246	6,908
Finished products	2,042	1,916
	11,173	14,795

## Note 6 - Property, Plant and Equipment, Net

	December 31	
	2011	2012
	US\$ thousands	
Machinery and equipment	2,873	3,240
Office furniture and equipment	294	294
Leasehold improvements	336	441
Property, plant and equipment	3,503	3,975
Accumulated depreciation	(2,666 )	(2,785 )
Property, Plant and equipment, net	837	1,190

Depreciation expenses for the years ended December 31, 2010, 2011 and 2012 were US\$ 416 thousand, US\$ 379 thousand and US\$ 454 thousand, respectively.

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Notes to the Consolidated Financial Statements

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## Note 7 - Assets Held and Liability for Employees' Severance Benefits

A. Under Israeli law and labor agreements, Silicom is required to make severance payments to retired or dismissed employees and to employees leaving employment in certain other circumstances.

In respect of the liability to the employees, individual insurance policies are purchased and deposits are made with recognized severance pay funds.

The liability for severance pay is calculated on the basis of the latest salary paid to each employee multiplied by the number of years of employment. The liability is covered by the amounts deposited including accumulated income thereon as well as by the unfunded provision.

B. According to Section 14 to the Severance Pay Law ("Section 14") the payment of monthly deposits by a company into recognized severance and pension funds or insurance policies releases it from any additional severance obligation to the employees that have entered into agreements with the company pursuant to such Section 14. Commencing July 1, 2008, the Company has entered into agreements with a majority of its employees in order to implement Section 14. Therefore, as of that date, the payment of monthly deposits by the Company into recognized severance and pension funds or insurance policies releases it from any additional severance obligation to those employees that have entered into such agreements and therefore the Company incurs no additional liability since that date with respect to such employees. Amounts accumulated in the pension funds or insurance policies pursuant to Section 14 are not supervised or administrated by the Company and therefore neither such amounts nor the corresponding accrual are reflected in the balance sheet.

C. Consequently, the assets held for employees' severance benefits reported on the balance sheet, in respect of deposits for those employees who have signed agreements pursuant to Section 14, represent the redemption value of deposits made through June 30, 2008. The liability for employee severance benefits, with respect to those employees, represents the liability of the Company for employees' severance benefits as of June 30, 2008.

As a result of the implementation of Section 14, as described above, the liability with respect to those employees is calculated on the basis of number of years of employment as of June 30, 2008, multiplied by the latest salary paid. The liability is covered by the amounts deposited, including accumulated income thereon, as well as by the unfunded provision. Such liability will be removed, either upon termination of employment or retirement.

D. Expenses recorded with respect to employees' severance payments for the years ended December 31, 2010, 2011 and 2012 were US\$ 372 thousand, US\$ 304 thousand and US\$ 382 thousand, respectively.



## Notes to the Consolidated Financial Statements

## Note 8 - Commitments and Contingencies

## A. Royalty commitments

The Company is obligated to pay royalties to the Government of Israel and the Korea Israel Industrial Research and Development Foundation on revenues from product sales related to research and development, which was undertaken with Government grants and other grants. Since January 1, 1997, royalty rates are between 2% to 5%. The royalty rates applicable for the Company's research and development projects are 2% - 3.5%, except for one project that took place in the period between July 1, 1997 - January 31, 2000, where the royalty rate is 4%.

Royalties are payable from the commencement of sales of each of these products until the cumulative amount of the royalties paid equals 100% of the dollar linked amounts of the grants received, without interest, for projects approved prior to December 31, 2000, and with LIBOR interest, for amounts received after that date.

The Company's total outstanding obligation in respect of royalty-bearing participations received or accrued, net of royalties paid or accrued before interest, amounted to approximately US\$ 2,960 thousand as at December 31, 2012 (US\$ 2,960 thousand as at December 31, 2011).

## B. Lease commitments

The premises and facilities occupied by the Company are leased under various operating lease agreements. Furthermore, the Company has entered into several operating lease agreements for motor vehicles in Israel.

The agreements are in New Israeli Shekel (NIS) or in NIS, linked to the Israeli Consumer Price Index.

The minimum future rental payments under the above leases at exchange rates in effect on December 31, 2012, are as follows:

	US\$ thousands
Year ended December 31	
2013	645
2014	145
2015 and on	58

Of the amounts above, US\$13 thousand in 2013, relate to related parties.

Rental expenses under the lease agreements for the years ended December 31, 2010, 2011 and 2012 were US\$ 542 thousand, US\$ 632 thousand and US\$ 676 thousand, respectively.

## C. Credit line

The Company has one line of credit provided to it by a bank (approximately US\$ 161 thousand). The bank is allowed to cancel or change the line of credit with no advance notice.

As at December 31, 2012, this credit line has not been used.

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Notes to the Consolidated Financial Statements

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## Note 8 - Commitments and Contingencies (Cont'd)

## D. Outstanding Legal Proceeding

On March 2, 2012 Internet Machines LLC, a Texas limited liability company filed a patent infringement lawsuit in the United States District Court for the Eastern District of Texas (the "Court") against numerous defendants (including many switch manufacturers) with respect to certain patents for switches, and included the Company's US subsidiary amongst the list of defendants named in such lawsuit. The lawsuit claims that the defendants have infringed certain patents purported to be owned by Internet Machines LLC and seeks unspecified compensation for damages as well as injunctive relief. The defendants filed answers and counterclaims to the complaint asserting that they do not infringe any claims of the asserted patents and the claims of the patents are invalid and/or unenforceable. On September 4, 2012, the Court granted the defendants' motion to stay the pending litigation. While one of the Company's switch suppliers (which is also named as a defendant in the aforesaid lawsuit) has agreed to indemnify the Company with respect to certain liabilities, there is no certainty that the Company will ultimately be able to collect all or any amounts under such indemnity should the Company be found liable under the lawsuit. The Company is unable at this time to assess the likelihood of an unfavorable outcome or range of potential loss.

## Note 9 - Shareholders' Equity

## Stock options to employees and directors

- A. On July 21, 2004, the Board resolved, subject to shareholders' approval that was given on December 30, 2004, to adopt the Share Option Plan (2004) (the "2004 Plan"). Option grants to employees under the 2004 Plan, including terms of vesting and the exercise price, are subject to the Board of Directors' approval. Option grants to directors and certain other officers are generally subject to the approvals of the Compensation Committee as well as Board of Directors, and grants to directors or a CEO will also generally have to be approved by the Shareholders. The term of the options shall not exceed 10 years from the date that the option was granted.

The 2004 plan initially covered up to 282,750 options and subsequent to an amendment by the board in 2007 it covered up to 582,750 options. In August 2012, the Board of Directors increased the number of the ordinary shares available for issuance under the 2004 plan by an additional 500,000. All options are at a conversion rate of 1:1.

- B. No options have been granted by the Company other than to employees and directors, as mentioned above.
- C. Options granted to Israeli residents may be granted under Section 102 of the Israeli Income Tax Ordinance pursuant to which the awards of options, or the ordinary shares issued upon their exercise, must be deposited with a trustee for at least two years following the date of grant. Under Section 102, any tax payable by an employee from the grant or exercise of the awards is deferred until the transfer of the awards or ordinary shares by the trustee to the employee or upon the sale of the awards or ordinary shares.

Gains on awards granted under the plan are subjected to capital gains tax of 25% to be paid by the employee, and the Company is not entitled to a tax deduction.



## Notes to the Consolidated Financial Statements

## Note 9 - Shareholders' Equity (cont'd)

## Stock options to employees and directors (cont'd)

D. On October 15, 2008, the Company granted, in the aggregate, 200,000 options to certain of its directors and employees under the 2004 Plan. In relation to this grant:

1. The exercise price for the options (per ordinary share) was US\$ 3.82 and the option expiration date was the earlier to occur of: (a) October 15, 2016; and (b) the closing price of the shares falling below US\$ 1.91 at any time after the date of grant. 50% of the options vest and become exercisable on the second anniversary of the date of grant and the additional 50% of the options vest and become exercisable on the third anniversary of the date of the grant.
2. The Company recognizes compensation expenses on these options based on estimated grant date fair value using the Monte Carlo option-pricing model with the following assumptions:

Average Risk-free interest rate (a)	3.73%
Expected dividend yield	0.0%
Average expected volatility (b)	112.42%
Termination rate	11%
Suboptimal rate (c)	3.45

- (a) Risk-free interest rate represents risk free US\$ zero-coupon US Government Bonds at time of grant.
- (b) Expected average volatility represents a weighted average standard deviation rate for the price of the Company's ordinary shares on the NASDAQ National Market.
- (c) Suboptimal rate represents the multiple of the increase in the market share price on the day of grant of the option which, should it come to pass, will lead to exercise of the option by the employee. It is the average suboptimal rate of the Company and similar companies.

3. No expenses were incurred during the year ended December 31, 2012 in relation to this grant. As at December 31, 2012, all expenses related to this grant were recognized.

## Notes to the Consolidated Financial Statements

## Note 9 - Shareholders' Equity (cont'd)

## Stock options to employees and directors (cont'd)

E. On December 21, 2010, the Company granted, in the aggregate, 137,500 options to certain of its directors and employees under the 2004 Plan. In relation to this grant:

1. The exercise price for the options (per ordinary share) was US\$ 18.82 and the Option expiration date was the earlier to occur of: (a) December 21, 2018; and (b) the closing price of the shares falling below US\$ 9.41 at any time after the date of grant. 50% of the options vest and become exercisable on the second anniversary of the date of grant and the additional 50% of the options vest and become exercisable on the third anniversary of the date of the grant.
2. The Company recognizes compensation expenses on these options based on estimated grant date fair value using the Binomial option-pricing model with the following assumptions:

Average Risk-free interest rate (a)	3.00%
Expected dividend yield	0.0%
Average expected volatility (b)	82.64%
Termination rate	9%
Suboptimal rate (c)	3.45

- (a) Risk-free interest rate represents risk free US\$ zero-coupon US Government Bonds at time of grant.
- (b) Expected average volatility represents a weighted average standard deviation rate for the price of the Company's ordinary shares on the NASDAQ National Market.
- (c) Suboptimal rate represents the multiple of the increase in the market share price on the day of grant of the option which, should it come to pass, will lead to exercise of the option by the employee. It is the average suboptimal rate of the Company and similar companies.

3. Compensation expenses incurred during the year ended December 31, 2012 in relation to this grant were approximately US\$ 389 thousand. As at December 31, 2012, there was approximately US\$ 149 thousand of unrecognized compensation costs related to this grant to be recognized over a weighted average period of 0.98 years.

## Notes to the Consolidated Financial Statements

## Note 9 - Shareholders' Equity (cont'd)

## Stock options to employees and directors (cont'd)

F. On September 13, 2012, the Company granted, in the aggregate, 240,000 options to certain of its directors and employees under the 2004 Plan. In relation to this grant:

1. The exercise price for the options (per ordinary share) was US\$ 15.28 and the Option expiration date was the earlier to occur of: (a) September 13, 2020; and (b) the closing price of the shares falling below US\$ 7.64 at any time after the date of grant. 50% of the options vest and become exercisable on the second anniversary of the date of grant and the additional 50% of the options vest and become exercisable on the third anniversary of the date of the grant.
2. The Company recognizes compensation expenses on these options based on estimated grant date fair value using the Binomial option-pricing model with the following assumptions:

Average Risk-free interest rate (a)	1.33 %
Expected dividend yield	0.0%
Average expected volatility (b)	64.71 %
Termination rate	9%
Suboptimal rate (c)	3.2

- (a) Risk-free interest rate represents risk free US\$ zero-coupon US Government Bonds at time of grant.
- (b) Expected average volatility represents a weighted average standard deviation rate for the price of the Company's ordinary shares on the NASDAQ National Market.
- (c) Suboptimal rate represents the multiple of the increase in the market share price on the day of grant of the option which, should it come to pass, will lead to exercise of the option by the employee. It is the average suboptimal rate of the Company and similar companies.

3. Compensation expenses incurred during the year ended December 31, 2012 in relation to this grant were approximately US\$ 155 thousand. As at December 31, 2012, there was approximately US\$ 1,084 thousand of unrecognized compensation costs related to this grant to be recognized over a weighted average period of 2.21 years.

## Notes to the Consolidated Financial Statements

## Note 9 - Shareholders' Equity (cont'd)

## Stock options to employees and directors (cont'd)

G. The following table summarizes information regarding stock options as at December 31, 2012:

Exercise price US\$	Options outstanding		Options exercisable	
	Number of options	Weighted average remaining contractual life (in years)	Number of options	Weighted average remaining contractual life (in years)
3.82	40,087	3.79	40,087	3.79
18.82	135,000	5.97	67,500	5.97
15.28	238,000	7.70	-	-
	413,087		107,587	

The aggregate intrinsic value of options outstanding as of December 31, 2011 and 2012 is US\$ 1,718 thousand and US\$ 1,199 thousand, respectively.

The aggregate intrinsic value of options exercisable as of December 31, 2011 and 2012 is US\$ 1,718 thousand and US\$ 566 thousand, respectively.

The total intrinsic value of options exercised during the year ended December 31, 2011 and 2012, is US\$ 609 thousand and US\$ 1,191 thousand, respectively.

The intrinsic value of the options at the date of grant is zero.



## Notes to the Consolidated Financial Statements

## Note 9 - Shareholders' Equity (cont'd)

## Stock options to employees and directors (cont'd)

H. The stock option activity under the abovementioned plans is as follows:

	Number of options	Weighted average exercise price US\$	Weighted average grant date fair value US\$
Balance at January 1, 2010	240,700		
Granted	137,500	18.82	8.69
Exercised	(70,375 )	3.68	1.81
Forfeited	(2,000 )	3.82	1.81
Balance at December 31, 2010	305,825		
Exercised	(45,400 )	3.62	1.75
Forfeited	(3,000 )	16.32	7.54
Balance at December 31, 2011	257,425		
Granted	240,000	15.28	6.54
Exercised	(82,338 )	3.35	1.81
Forfeited	(2,000 )	15.28	6.54
Balance at December 31, 2012	413,087		
Exercisable at December 31, 2012	107,587		

I. During 2010, 2011 and 2012, the Company recorded share-based compensation expenses. The following summarizes the allocation of the stock-based compensation expenses:

	Year ended December 31		
	2010 US\$ thousands	2011 US\$ thousands	2012 US\$ thousands
Cost of sales	33	24	46
Research and development costs	71	96	130
Selling and marketing expenses	65	134	159
General and administrative expenses	62	183	209

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## Notes to the Consolidated Financial Statements

## Note 10 - Sales

## A. Information on sales by geographic distribution:

The Company has one operating segment.

Sales are attributed to geographic distribution based on the location of the customer.

	Year ended December 31		
	2010	2011	2012
	US\$ thousands		
North America	22,071	29,627	33,606
Europe	4,174	5,174	7,277
Rest of the world	4,154	4,832	7,846
	30,399	39,633	48,729

All property, plant and equipment are located in Israel.

## B. Sales to single customers exceeding 10% of sales (US\$ thousands):

	Year ended December 31		
	2010	2011	2012
	US\$ thousands		
Customer "A"	3,440	4,882	10,809
Customer "B"	4,160	4,195	8,714
Customer "C"	3,214	*	*

\*

Less than 10% of sales.

## Note 11 - Financial Income (Expenses), Net

	Year ended December 31		
	2010	2011	2012
	US\$ thousands		
Interest income	1,277	1,292	1,360
Interest expenses	(416 )	(499 )	(561 )
Exchange rate differences, net	(130 )	(231 )	96
Bank charges	(114 )	(123 )	(143 )
	617	439	752



Notes to the Consolidated Financial Statements

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## Note 12 - Taxes on Income

## A. Measurement of results for tax purposes under the Israeli Income Tax Regulations (Rules for Maintaining Accounting Records of Foreign Invested Companies and Certain Partnerships and Determining Their Taxable Income) - 1986

As a "foreign invested company" (as defined in the Israeli Law for the Encouragement of Capital Investments-1959), the Company's management has elected to apply Income Tax Regulations (Rules for Maintaining Accounting Records of Foreign Invested Companies and Certain Partnerships and Determining Their Taxable Income) - 1986 from January 1, 2002. Accordingly, its taxable income or loss is calculated in US Dollars.

## B. Israel tax reform

On July 14, 2009, the Israeli parliament passed the Economic Efficiency Law (Legislation Amendments for Implementation of the 2009 and 2010 Economic Plan) - 2009, which provided, inter alia, a gradual reduction in the corporate tax rate to 18% as from the 2016 tax year. According to the aforementioned amendments, the corporate tax rate for the year 2010 - 25% and for the year 2011-24%.

On December 5, 2011 the Israeli parliament approved the Law to Change the Tax Burden (Legislative Amendments) - 2011. According to the law the tax reduction that was provided in the Economic Efficiency Law, as aforementioned, will be cancelled and the company tax rate will be 25% as from 2012.

Current taxes for the periods reported in these financial statements are calculated according to the tax rates specified in the Economic Efficiency Law.

## C. Tax benefits under the Israeli Law for the Encouragement of Capital Investments, 1959 (hereinafter - the "Law")

## 1. Rates

- a. The Company has elected to be taxed under the alternative benefits method, whereby the Company waives grants in return for tax exemptions. For the manufacturing plant in Yokneam the Company is entitled to an exemption from tax on its taxable income for a period of ten years beginning from the year of election; For the research and development center the Company is entitled to an exemption from tax on its taxable income for two years beginning from the year of election, and not more than 25%, on its taxable income in the next eight years.

## Notes to the Consolidated Financial Statements

## Note 12 - Taxes on Income (cont'd)

## C. Tax benefits under the Israeli Law for the Encouragement of Capital Investments, 1959 (hereinafter - the "Law") (cont'd)

## 1. Rates (cont'd)

b. In the event of distribution by the Company of cash dividends out of its retained earnings that were tax exempt due to the "Approved Enterprise" status, the Company would be subject to a 25% corporate tax on the amount distributed, and a further 15% withholding tax would be deducted from the amounts distributed to the shareholders.

c. Should the Company 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 for the applicable year.

## 2. Accelerated depreciation

The Company is entitled to claim accelerated depreciation for a period of five years in respect of property, plant and equipment of an "Approved Enterprise". The Company has not utilized this benefit to date.

## 3. Conditions for entitlement to the tax benefits

Entitlement to the tax benefits of the Company's "Approved Enterprise" is dependent upon the Company fulfilling the conditions stipulated by the Law and the regulations published thereunder, as well as the criteria set forth in the approval for the specific investment in the Company's "Approved Enterprise".

In the event of failure to comply with these conditions, the tax benefits may be canceled, and the Company may be required to refund the amount of the cancelled benefits, with the addition of linkage differences and interest. As of the date of these financial statements, the Company meets the compliance with these conditions.

## 4. Amendments to the Law

On March 30, 2005, the Israeli Parliament approved a reform of the above Law. The primary changes are as follows:

(a) Companies that meet the criteria of the Benefited Enterprise (Formerly known as Alternative Path of Approved Enterprise) benefits will receive those benefits without prior approval. In addition, there will be no requirement to file reports with the Investment Center. Companies will be required to notify the Israeli Tax Authorities regarding the implementation of the Benefited Enterprise. Audits will take place via the Israeli Income Tax Authorities as part of the tax audits. Request for pre-ruling is possible.

(b) Tax benefits of the Benefited Enterprise comparing to regular corporate tax regulations, include lower tax rates or no tax depending on the area and the path chosen, lower tax rates on dividend income and accelerated tax depreciation. The tax benefits do not differ from those prior the amendment.



Notes to the Consolidated Financial Statements

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## Note 12 - Taxes on Income (cont'd)

## C. Tax benefits under the Israeli Law for the Encouragement of Capital Investments, 1959 (hereinafter - the "Law") (cont'd)

## 4. Amendments to the Law (cont'd)

(c) In order to receive the tax benefits in the Grant Path or the Benefited Enterprise, the "Industrial Company" must contribute to the economic independence of Israel's economy in one of the following ways:

1. Its primary activity is in the Biotechnology or Nanotechnology fields and pre-approval is received from the head of research and development at the Office of the Chief Scientist;
2. Its revenue from a specific country is not greater than 75% of its total revenues that year;
3. 25% or more of its revenues are derived from a specific foreign market of at least 12 million residents.

(d) Upon the establishment of a "Benefited Enterprise", an investment of at least NIS 300 thousand in production machinery and equipment within three years is required.

(e) For an expansion, a company is required to invest within three years the higher of NIS 300 thousand in production machinery and equipment or a certain percentage of its existing production machinery and equipment.

The amendments to the Law do not retroactively apply for investment programs having an "Approved Enterprise" approval certificate from the Investment Center issued up to December 31, 2004. Therefore, the amendments do not impact an existing "Approved Enterprise" that received prior written approval. The new tax regime shall apply for a new "Approved Enterprise" and for an "Approved Enterprise" expansion for which the elected year is 2004 onwards.

In respect to the abovementioned amendments to the Law, the Company selected the tax years 2004, 2006, 2009 and 2012 as the years of election. The Israeli Tax Authorities, in a pre-ruling issued to the Company, have established a formula for the allocation of the Company's taxable income that will be subject to the relevant different tax rates as permitted under the amendments to the Law.

On December 29, 2010 the Knesset approved the Economic Policy Law for 2011-2012, which includes an amendment to the Law for the Encouragement of Capital Investments – 1959 (hereinafter – "the Amendment to the Law"). The Amendment to the Law was published in the Official Gazette on January 6, 2011. The Amendment to the Law is effective from January 1, 2011 and its provisions will apply to preferred income derived or accrued in 2011 and thereafter by a preferred company, per the definition of these terms in the Amendment to the Law.



Notes to the Consolidated Financial Statements

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## Note 12 - Taxes on Income (cont'd)

## C. Tax benefits under the Israeli Law for the Encouragement of Capital Investments, 1959 (hereinafter - the "Law") (cont'd)

## 4. Amendments to the Law (cont'd)

Companies can choose to not be included in the scope of the Amendment to the Law and to stay in the scope of the law before its amendment until the end of the benefits period. The 2012 tax year is the last year companies can choose as the year of election, providing that the minimum qualifying investment began in 2010.

The Amendment provides that only companies in Development Area A will be entitled to the grants track and that they will be entitled to receive benefits under this track and under the tax benefits track at the same time. In addition, the existing tax benefit tracks were eliminated (the tax exempt track, the "Ireland track" and the "Strategic" track) and two new tax tracks were introduced in their place, a preferred enterprise and a special preferred enterprise, which mainly provide a uniform and reduced tax rate for all the company's income entitled to benefits, such as: for a preferred enterprise – in the 2011-2012 tax years – a tax rate of 10% for Development Area A and of 15% for the rest of the country, in the 2013-2014 tax years – a tax rate of 7% for Development Area A and of 12.5% for the rest of the country, and as from the 2015 tax year – 6% for Development Area A and 12% for the rest of the country. Furthermore, an enterprise that meets the definition of a special preferred enterprise is entitled to benefits for a period of 10 consecutive years and a reduced tax rate of 5% if it is located in Development Area A or of 8% if it is located in a different area.

The Amendment to the Law also provides that no tax will apply to a dividend distributed out of preferred income to a shareholder that is a company, for both the distributing company and the shareholder. A tax rate of 15% shall continue to apply to a dividend distributed out of preferred income to an individual shareholder or foreign resident, subject to double taxation prevention treaties, which means that there is no change from the existing law. Furthermore, the Amendment to the Law provides relief (hereinafter – "the relief") with respect to tax paid on a dividend received by an Israeli company from profits of an approved/alternative/beneficiary enterprise that accrued in the benefits period according to the version of the law before its amendment, if the company distributing the dividend notifies the tax authorities by June 30, 2015 that it is applying the provisions of the Amendment to the Law and the dividend is distributed after the date of the notice.

The Company meets the conditions provided in the amendment to the Law for the Encouragement of Capital Investments for inclusion in the scope of the tax benefits track. The amendment to the Law will not have a material impact on the Company's consolidated financial statements as of December 31, 2012.

On November 5, 2012 the Knesset passed Amendment No. 69 and Temporary Order to the Law for the Encouragement of Capital Investments – 1959 (hereinafter: "the temporary order"), which offers a reduced tax rate arrangement to companies that received an exemption from corporate tax under the aforesaid law. The temporary order provides that companies that choose to apply the temporary order (effective for one year), will be entitled to a reduced tax rate on the "release" of exempt profits (hereinafter: "the beneficiary corporate tax rate"). The release of exempt profits will make it possible to distribute them without additional tax at the company level and will also make it possible to use the profits without the restrictions that applied to the use of the exempt profits.

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Notes to the Consolidated Financial Statements

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## Note 12 - Taxes on Income (cont'd)

## C. Tax benefits under the Israeli Law for the Encouragement of Capital Investments, 1959 (hereinafter - the "Law") (cont'd)

## 4. Amendments to the Law (cont'd)

The beneficiary corporate tax rate will be determined according to the rate of exempt profits the company chooses to release from its entire exempt profits, and will be between 40% and 70% of the corporate tax rate that would have applied to the revenue in the year it was produced if it had not been exempt, but in any event no less than 6%.

Furthermore, a company that chooses to pay a beneficiary corporate tax rate will have to invest in an industrial enterprise up to 50% of the tax saving it obtained, within a period of 5 years beginning from the year of notice. Failure to comply with this condition will require the company to pay additional corporate tax.

The Company is still examining whether to apply the temporary order and as at the date of approval of the financial statements it has not yet decided on the matter.

## D. Tax benefits under the Israeli Law for Encouragement of Industry (Taxes), 1969

The Company considers that it currently qualifies as an "Industrial Company" under the above Law. As such, it is entitled to certain tax benefits, mainly the right to deduct share issuance costs over three years for tax purposes in the event of a public offering.

## E. Taxation of the subsidiary

The subsidiary files tax returns to US Federal tax authorities and to state tax authorities in the states of New Jersey and California.

## F. Tax assessments

For the Israeli jurisdiction the Company has final tax assessments for all years up to and including the tax year ended December 31, 2008. For the US Federal jurisdictions, the subsidiary has final tax assessments for all years up to and including the tax year ended December 31, 2008. For the New-Jersey state jurisdiction, the subsidiary has final tax assessments for all years up to and including the tax year ended December 31, 2007. For the California state jurisdiction, the subsidiary has open tax assessments for 2011 and 2012.

## Notes to the Consolidated Financial Statements

## Note 12 - Taxes on Income (cont'd)

G. Income before income taxes and income taxes expense (benefit) included in the consolidated statements of operations

	Year ended December 31		
	2010	2011	2012
	US\$ thousands		
Income before income taxes:			
Israel	6,507	8,899	10,086
Foreign jurisdiction	9	11	695
	6,516	8,910	10,781
Current taxes:			
Israel	657	619	784
Foreign jurisdiction	-	-	116
	657	619	900
Tax benefits relating to prior years:			
Israel	(12 )	(38 )	(12 )
Deferred taxes:			
Israel	148	73	(3 )
Foreign jurisdiction	8	13	25
	156	86	22
Income tax expense	801	667	910

## Notes to the Consolidated Financial Statements

## Note 12 - Taxes on Income (cont'd)

## H. Deferred income taxes

1. A portion of the Company's income is tax exempt due to the "Benefited enterprise" status granted to its production facilities, as described above.

2. The tax effects of significant items comprising the Company's deferred tax assets are as follows:

	December 31 2011 US\$ thousands	December 31 2012 US\$ thousands
Deferred tax assets:		
Accrued employee benefits	148	147
Research and development costs	3	8
Tax loss carryforwards	87	-
Fixed assets	6	5
Other	2	1
Total gross deferred tax assets	246	161
Less: valuation allowance	(63 )	-
Net deferred tax assets	183	161
In Israel	158	161
Foreign jurisdictions	25	-
Net deferred tax assets	183	161
Current	48	47
Non-current	135	114
Total	183	161

The net change in valuation allowance for the years ended December 31, 2010, 2011 and 2012 was a decrease of US\$ 17 thousand and an increase of US\$ 12 thousand and a decrease of US\$ 63 thousand, respectively.

In 2010 and in 2011, all of the valuation allowance referred to loss carry-forward related to Silicom Connectivity Solutions, Inc.

In 2012 Silicom Connectivity Solutions, Inc has used all of its loss carry-forward and therefore all related deferred tax assets and valuation allowance were derecognized.



## Notes to the Consolidated Financial Statements

## Note 12 - Taxes on Income (cont'd)

## I. Reconciliation of the statutory tax expense to actual tax expense

	Year ended December 31		
	2010	2011	2012
	US\$ thousands		
Income before income taxes	6,516	8,910	10,781
Statutory tax rate in Israel	25 %	24 %	25 %
Computed expected tax	1,629	2,138	2,695
Increase (decrease) in taxes resulting from:			
Non-deductible operating expenses	25	123	159
Prior year adjustments	(12 )	(38 )	(12 )
Change in valuation allowance	(17 )	12	(63 )
Tax effect due to "Approved Enterprise" status	(832 )	(1,640 )	(2,063 )
Taxes related to foreign jurisdictions	-	-	30
Changes in tax rate and other	8	72	164
Income tax expense	801	667	910

## J. Accounting for uncertainty in income taxes

ASC 740-10 clarifies the accounting for uncertainty in income taxes recognized in an enterprise's financial statements. This standard prescribes a minimum recognition threshold a tax position is required to meet before being recognized in the financial statements. ASC 740-10 requires significant judgment in determining what constitute an individual tax position as well as assessing the outcome of each tax position.

During 2010, 2011 and 2012 the Company and its subsidiary did not have any unrecognized tax benefits and thus, no related interest and penalties were accrued.

In addition, the Company and its subsidiary do not expect that the amount of unrecognized tax benefits will change significantly within the next twelve months.

Notes to the Consolidated Financial Statements

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Note 13 - Fair Value of Financial Instruments

The Company's financial instruments consist of cash and cash equivalents, short-term deposits, marketable securities, trade and other receivables and trade accounts payable. The carrying amounts of these financial instruments, except for marketable securities, approximate fair value because of the short maturity of these investments. Assets held for severance benefits are recorded at their current cash redemption value.

The fair value of marketable securities is presented in Note 4 to these consolidated financial statements.

Note 14 - Subsequent Events

On January 14, 2013, Silicom's Board of Directors has adopted a policy for distributing dividends, subject to all applicable laws. According to this policy, each year the Company will distribute a dividend of up to 50% of its annual distributable profits.

On March 18, 2013 Silicom's Board of Directors declared a dividend of US \$0.55 per share payable on April 17, 2013 to shareholders of record as of April 4, 2013, and in the aggregate amount of approximately US \$3.9 million for 2012.

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